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Taxation of Business Intangible Capital

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INTRODUCTION

The value and earning capacity associated with intangibles such as copyrights, patents, trademarks, know-how, and goodwill are important aspects of any business.[1] Despite recognized defects in the federal taxation of intangibles,[2] the Tax Reform Act of 1986 ("1986 Act") failed to address intangibles.[3] Given the comprehensive review of our tax laws

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[1] *See generally* G. BECKER, HUMAN CAPITAL 15-44 (2d ed. 1975); K. CLARKSON, INTANGIBLE CAPITAL AND RATES OF RETURN 20-22 (1977); L. TELSER, COMPETITION, COLLUSION, AND GAME THEORY 356-57 (1972); Ben-Zion, *The Investment Aspect of Nonproduction Expenditures: An Empirical Test,* J. ECON. & BUS. 224, 227-28 (1978); Brozen, *Foreword* to K. CLARKSON, *supra,* at 7-10; Grabowski & Mueller, *Industrial Research and Development, Intangible Capital Stocks, and Firm Profit Rates,* 9 BELL J. ECON. 328, 328-32 (1978); Hirschey, *Intangible Capital Aspects of Advertising and R&D Expenditures,* 30 J. INDUS. ECON. 375, 375-79 (1982).

[2] The Second Circuit, in often-quoted language, has noted:

> In the realm of intangibles . . . the rulings and decisions are in a state of hopeless confusion . . . . The taxpayer, who may be exposed to interest and penalties for guessing wrong, is entitled to reasonably clear criteria or standards to let him know what his rights and duties are. As matters stand, the following quotation alluded to by a court of appeals of another circuit, which was wrestling with this general area of federal income tax law, is pertinent,
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> "This kind can come forth by nothing, but by prayer and fasting."

Briarcliff Candy Corp. v. Commissioner, 475 F.2d 775, 785 (2d Cir. 1973). *See generally* B. BITTKER, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶¶ 20.4.4-.4.5 (1981); Doernberg & Hall, *The Tax Treatment of Going-Concern Value,* 52 GEO. WASH. L. REV. 353 (1984); Gregorcich, *Amortization of Intangibles: A Reassessment of the Tax Treatment of Purchased Goodwill,* 28 TAX LAW. 251 (1975); Grigsby & Cotter, *Amortization of Certain Intangibles,* 30 U.S.C. TAX INST. 543 (1978); Gunn, *The Requirement That a Capital Expenditure Create or Enhance an Asset,* 15 B.C. INDUS. & COM. L. REV. 443 (1974); Lee, *Start-Up Costs, Section 195, and Clear Reflection of Income: A Tale of Talismans, Tacked-On Tax Reform, and a Touch of Basics,* 6 VA. TAX REV. 1 (1986); Wilberding, *An Individual's Business Investigation Expenses: An Argument Supporting Deductibility,* 26 TAX LAW. 219 (1973); Note, *Taxation: Start-up Cost Treatment Under § 195: Tax Disparity in Disguise,* 36 OKLA. L. REV. 449 (1983); Recent Developments, *Deductibility of Start-up Expenditures under Section 162—The "Clear-Reflection-of-Income" Test,* 61 CORNELL L. REV. 618 (1976)[hereinafter *Deductibility*].

[3] Tax Reform Act of 1986, Pub. L. No. 99-514, 99th Cong., 2d Sess., 1986 U.S.

during the development of the 1986 Act, the failure to deal with intangibles is puzzling. This Article argues that the source of the current intangibles defects is the basic approach taken by Congress, the courts, and the Treasury to key issues. By adopting a different approach, this Article develops a legislative proposal for the taxation of intangibles that is missing from the 1986 Act.

Part I of this Article examines the basic criticisms of current law based on the accepted tax policy criteria of simplicity, equity, and neutrality. It notes that even though the evidence indicates that there is an economic similarity between depreciable assets and intangible value, current law treats them differently. I conclude that, in addition to the complexity associated with the current differing tax treatment for assets and intangible value, there are three severe equity and neutrality problems:[4] (1) an implicit tax preference for many expenditures related

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CODE CONG. & ADMIN. NEWS (100 Stat.) (to be codified in scattered sections of 26 U.S.C.).

In February, 1986, the Treasury prepared a revenue estimate for a proposal that would have disallowed the deduction of 20% of advertising expenditures, increasing revenues approximately $4 billion a year. *See* Wall St. J., Feb. 28, 1986, at 54, col. 1. This proposal went nowhere. It would have addressed only one of the three problems in current law, and that one not very well. In the early 1970's, the American Bar Association Tax Section failed in an attempt to deal with this area. *See* Committee on Depreciation and Amortization, American Bar Association, *Report,* 27 TAX LAW. 554 (1974).

[4] There, of course, are other problems associated with the taxation of intangible value. The following lists a few of the problems that will not be covered in this Article because similar problems are present with respect to tangible assets. The different tax consequences for the sale of a separately transferable intangible asset, as opposed to a lease or license of the intangible, reaches confused and unsatisfactory results. *See* I.R.C. § 1235 (1982 & Supp. III 1985) (sale or exchange of patents). *See generally* Harding, *Obtaining Capital Gains Treatment on Transfers of Know-How,* 37 TAX LAW. 307 (1984); Olson, *Federal Income Taxation of Patent and Know-How Transfers,* 28 ST. LOUIS U.L.J. 537 (1984). Similarly, the line between a transfer of intangibles such as know-how and the provision of services (also taxed differently) is poorly drawn. *See* Harding, *supra,* at 312-14; Olson, *supra.* The law determining an arm's length royalty for intangibles is confused. *See* I.R.C. § 482 (1982 & West Supp. 1987) (last sentence) (special rule for determining intangibles' royalties); H.R. REP. NO. 426, 99th Cong., 1st Sess. 423-25 (1985). Issues arise involving expenditures that arguably relate to intangible value, but really relate to something else. *See* I.R.C. § 276(a)(1) (1982) (advertising expenditures that inure to benefit of political party are nondeductible). The tax treatment of some charitable contributions that arguably relate to intangible value, such as (i) when contributions to a charity generate goodwill for the donor, (ii) when donations of computers to a university improve the market for the computers, or (iii) when donations to an educational organization enable the donor to hire more qualified employees, presents problems. For example, in Singer Co. v. United States, 449 F.2d 413 (Ct. Cl. 1971), the corporation was not allowed charitable deductions with respect to bargain sales of sewing machines to schools, because the goodwill-like benefit to the corporation undermined the charitable nature of the transactions. Finally, there are problems in the law pertaining to the source of intangible income and deductions for foreign tax credit and U.S. tax jurisdiction purposes. *See* S. REP. NO. 313, 99th Cong., 2d Sess. 703-06 (1986); H.R. REP. NO. 426, 99th Cong., 1st Sess. 383-87 (1985); 2

to intangible value,[5] (2) an unjustified extra tax on sales of businesses with intangible value,[6] and (3) a disadvantageous tax preference for going concerns.[7]

Part II reinforces Part I's critique of current law by demonstrating that the current problems stem, not from a rejection of accepted tax policy criteria, but from an unfortunate approach to intangible value. This discussion begins by analyzing the basic rules for the taxation of business expenditures.[8] I conclude that this current regime is in general better than alternative regimes, because it minimizes problems of asset valuation, transactional accounting, and accounting for expectations. The nature of intangible value, particularly the uncertainty in identifying and valuing it at any given moment, however, presents problems for

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OFFICE OF THE SECRETARY, U.S. DEPARTMENT OF THE TREASURY, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH 365-66 (1984) [hereinafter TREASURY I].

Issues involving the minimum taxes and selected issues involving international taxation are considered only in the footnotes of this Article. This Article is further confined to business taxation. For instance, while individuals may invest in themselves through education, health care, etc., this Article only considers third-party investments in individuals. *Cf.* Schultz, *Investment in Human Capital,* 51 AMER. ECON. REV. 1, 13 (1961) (Individuals make substantial investments in their own human capital.). This Article also does not consider the different tax treatments of payments for damaging an individual's business goodwill and damages for personal injury. *See, e.g.,* Roemer v. Commissioner, 716 F.2d 693 (9th Cir. 1983). This Article does not consider the taxation of benefits to individuals from business expenditures on intangible capital, such as training or a goodwill safari. Finally, this Article does not take into account the additional complexity of the "double taxation" of corporate income. It is assumed that the purpose of the corporate income tax is to impose an income tax much like the individual income tax. *See generally* C. MCLURE, MUST CORPORATE INCOME BE TAXED TWICE? (1979); *American Law Institute Federal Income Tax Project—Subchapter C—Proposals of the American Law Institute on Corporate Acquisitions and Dispositions and Reporter's Study on Corporate Distributions* 341-53 (W. Andrews rep. 1982) [hereinafter *ALI*]; Bradford, *The Incidence and Allocation Effects of a Tax on Corporate Distributions,* 15 J. PUB. ECON. 1 (1981); McLure, *Corporate Income Tax: Restoration, Integration, or Elimination?,* in TO PROMOTE PROSPERITY: U.S. DOMESTIC POLICY IN THE MID-1980'S 303 (J. Moore ed. 1984); Shakow, *Taxation Without Realization: A Proposal for Accrual Taxation,* 134 U. PA. L. REV. 1111, 1132-37 (1986).

[5] *See* Gregorcich, *supra* note 2, at 254-58; McDonald, *Goodwill and the Federal Income Tax,* 45 VA. L. REV. 645, 648-54 (1959); *Deductibility, supra* note 2, at 632-33; *infra* notes 69-138 and accompanying text.

[6] *See* Gregorcich, *supra* note 2, at 258-71; Schenk, *Depreciation of Intangible Assets: The Uncertainty of Death and Taxes,* 13 WAYNE L. REV. 501, 528-29 (1967); *infra* notes 139-174 and accompanying text.

[7] *See* Note, *supra* note 2, at 466 (more favorable treatment of existing businesses); *infra* notes 175-191 and accompanying text.

[8] The basic rules for the taxation of business expenditures generally allow deductions for business expenses as made, but treat expenditures related to depreciable assets as costs of the assets that are only deductible later through the depreciation allowance. For a basic economic discussion of the traditional approach, see *infra* text accompanying notes 192-222.

the general regime. Congress, the courts, and the Treasury have dealt with these problems by treating expenditures related to intangible value similarly to expenditures related to assets only when it is both (i) easy to identify the associated value, either because the value is represented by an asset, such as a patent, or because the value is simple to measure, such as goodwill expressly paid for when a business is purchased, and (ii) easy to identify the relationship between the expenditure and the associated value. This fairly inflexible, transactional, asset-oriented approach side-steps the need to deal with the uncertain and otherwise difficult nature of intangible value. By identifying the reasons for the current problems, Part II also motivates a possible reform.

Part III proposes a more flexible non-asset oriented approach to taxing intangible value. This approach is directed toward reducing the current problems, while being consistent with the concerns underlying the basic rules for the taxation of expenditures. Part III examines how the proposed approach has precedent in analogous areas of current and past law. It concludes with a review of both the advantages and disadvantages associated with this proposal.

Parts I through III are predicated on a tax system without explicit tax preferences (other than for capital gain), tax penalties, or inflation. Part IV incorporates these additional concerns into the proposal. It also demonstrates that they do not affect the basic conclusions of Parts I through III, and indeed can be dealt with more satisfactorily under the proposal in Part III.

I. CRITIQUE

A. *Tax Policy Criteria*

Tax provisions generally are evaluated using three criteria: simplicity, equity, and neutrality.[9] The simplicity criterion is virtually self-explanatory. A tax provision is sound when it is simple for taxpayers to comply with and for the I.R.S. to enforce. Simplicity assures that the provision does not impose undue administrative costs upon those complying with and enforcing the provision.[10]

The equity criterion looks to evenhanded treatment. A tax provision is fair when similarly situated taxpayers are treated similarly. An inequitable tax provision is objectionable per se and also is likely to

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[9] *See* S. REP. No. 313, 99th Cong., 2d Sess. 3-8 (1986); B. BITTKER, L. STONE & W. KLEIN, FEDERAL INCOME TAXATION 11-16 (6th ed. 1984) [hereinafter BITTKER & STONE].

[10] *See* 1 TREASURY I, *supra* note 4, at 15-16 (discussing simplicity in taxation and how such simplicity results in reduced administrative costs).

damage taxpayers' perceptions of the tax, undermining taxpayers' compliance with the tax, political support for the tax, and, perhaps, citizens' willingness to pay for government through taxes.[11]

Neutrality requires that a tax provision not modify behavior unless there are good reasons to believe that the modified behavior is preferable to the unmodified behavior.[12] When a tax modifies behavior, it imposes a burden on taxpayers in addition to the tax, the burden of behaving differently.[13] Unlike the tax itself, the additional burden does not necessarily benefit the government and therefore is troubling. Consequently, unless this burden is justified, a tax provision should avoid it.[14]

This Article's critique of current law is based solely upon these

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[11] *See* 1 TREASURY I, *supra* note 4, at 13-17. Evenhanded treatment generally is referred to as "horizontal" equity. BITTKER & STONE, *supra* note 9, at 12. There is another equity notion: "vertical" equity. *Id.* A tax satisfies the vertical equity criterion if those better off pay relatively more tax than those less well off. *Id.* The vertical equity criterion rarely comes into play in evaluating a narrow tax provision, like the taxation of intangible capital. *Cf.* 1 TREASURY I, *supra* note 4, at 15 (discussing vertical equity in taxation). I do not use it to appraise the taxation of intangible capital.

[12] *See* 1 TREASURY I, *supra* note 4, at 13.

[13] *See* W. BAUMOL & A. BLINDER, ECONOMICS: PRINCIPLES AND POLICY 604-05 (3d ed. 1985).

[14] The neutrality criterion sometimes is stated more strongly as an efficiency criterion. The idea underlying the efficiency criterion is that the behavior that would occur in the absence of governmental modification probably represents the economy operating as efficiently as possible, so that any tax-induced modification of this behavior reduces economic efficiency. *See* S. REP. NO. 313, 99th Cong., 2d Sess. 7-8 (1986). There are those who question the efficiency criterion's assumption that an unregulated economy is socially optimal. *See* J. GALBRAITH, THE AFFLUENT SOCIETY 32-34 (3d ed. 1976).

Even assuming the general validity of the efficiency criterion, there are two problems with applying the criterion when looking at a given narrow tax provision. First, there is no reason, per se, to believe that a slight reduction in the tax system's effect on behavior will increase efficiency. Other tax provisions or governmental regulations may have so changed the economy from what it would be in the absence of governmental modification that an additional modification from a tax provision might countermand some other efficiency-reducing effect of government or otherwise increase economic efficiency. *See generally* Lipsey & Lancaster, *The General Theory of Second Best,* 24 REV. ECON. STUD. 11 (1956) (the classic article suggesting that once government has changed a number of economic decisions, eliminating one changed decision might not increase efficiency). Second, in looking at most tax provisions, the issue is not whether to modify behavior, but which of two modifications is preferable. There are no ready standards by which to measure the relative effects of behavior changes from different specific provisions. *See* Ballard, Shoven & Whalley, *The Total Welfare Cost of the United States Tax System: A General Equilibrium Approach,* 38 NAT'L TAX J. 125, 125 (1985). For example, it is not clear whether discouraging work effort (perhaps through taxing wages) results in greater or less efficiency than discouraging saving (perhaps through taxing the return on savings). *See* 1 TREASURY I, *supra* note 4, at 198-99; Bradford, *The Economics of Tax Policy Toward Savings,* in THE GOVERNMENT AND CAPITAL FORMATION 11, 20-38 (G. von Furstenberg ed. 1980). This Article uses the more modest neutrality criterion to avoid the problems associated with the efficiency criterion.

three criteria.[15] Aspects of current law can be criticized on other grounds. For example, some believe that certain advertising is bad because it reduces competition, distorts values, and misleads.[16] These commentators might criticize current law because it does not penalize advertising.[17] Some believe that investment in human beings is desirable.[18] These individuals might criticize current law for having too few incentives for this investment. These concerns raise policy issues beyond the scope of this Article.

Current law is objectionable in terms of all three criteria: simplicity, equity, and neutrality. The complexity of current law will be evident in the discussion below and therefore the simplicity criterion needs no additional explication. In order to examine the equity and neutrality concerns, it is helpful to review the evidence on the economics of intangible value in a business. The analysis does not take into account explicit tax preferences (other than the preference for capital gain), tax penalties, or inflation until Part IV.

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[15] A current fad in tax policy is to evaluate provisions in terms of the financial accounting notion of "matching." *See, e.g.,* S. REP. NO. 313, 99th Cong., 2d Sess. 140 (1986) (principal consideration underlying section 263A is "mismatching"). Matching requires that gross income and associated deductions be taken into account at the same time. *Elements of Financial Statements of Business Enterprises,* Statement of Financial Accounting Concepts No. 3, §§ 84-89 (Fin. Accounting Standards Bd. 1980). Many of the concerns of this Article can be seen as mismatching problems. I do not adopt a matching perspective, however, for three reasons: first, the analysis under the three criteria reaches all concerns that would be identified from a matching perspective; second, a matching perspective does little to solve the concerns once identified, *see infra* text accompanying notes 225-237, 260-69; and, third, matching analysis frequently leads to incorrect tax results, as policy judgments are hidden in assumptions about which income and deductions are to be matched, *see, e.g.,* Mundstock, *Accelerated Depreciation and the Interest Deduction: Can Two Rights Really Make a Wrong?,* 29 TAX NOTES 1253, 1253-54 (1985) (Current deduction of interest associated with income deferred because of accelerated depreciation is still proper.).

It is not clear that matching is always sound policy. Matching is abandoned when it is perceived as being too generous to taxpayers. *See, e.g.,* I.R.C. § 461(h) (Supp. III 1985 & West Supp. 1987) (deductions attributable to current income deferred to later periods); American Auto. Ass'n v. United States, 367 U.S. 687 (1961) (income taxed prior to associated deductions). This is not surprising, since the matching notion serves financial accounting purposes that are frequently inconsistent with sound tax policy. *See infra* text accompanying notes 323-26. For financial accounting purposes, it is important that a proper net profit be determined for each year. This supports matching. For tax purposes, each tax year does not stand by itself. It is acceptable that a given year's taxable income be mismeasured (which is inevitable under current tax accounting regimes), as long as the "error" is offset by errors in other years so that the present value of taxes does not vary substantially from the perfect result.

[16] *See, e.g.,* W. COMANOR & T. WILSON, ADVERTISING AND MARKET POWER 252 (1974).

[17] *See* J. SIMON, ISSUES IN THE ECONOMICS OF ADVERTISING 278-85 (1970); Doyle, *Economic Aspects of Advertising: A Survey,* 78 ECON. J. 570, 597-98 (1968).

[18] *See, e.g.,* Schultz, *supra* note 4, at 14-15.

B. *The Nature of Intangible Capital*

It is necessary to define two terms: "intangible capital" and "intangible capital expenditures." "Intangible capital" is value in a business that is not attributable to tangible assets or cash and similar cash-equivalent intangibles (such as foreign currency, bank deposits, etc.).[19] Examples are value attributable to copyrights, trademarks, service marks, goodwill, patents, and employees who are trained, knowledgeable, efficient, healthy, and happy. "Intangible capital expenditures" are expenditures that increase the amount of intangible capital[20] at the end of the year in which the expenditures are made.[21] Examples are ex-

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[19] A business makes expenditures to form the business entity, to acquire equity capital, and to borrow money. These expenditures may be viewed as a means of increasing the value of the business. Alternatively, these expenditures may be viewed as the costs to investors of participating in the business. Because the second view is more appropriate, and for purposes of simplifying the discussion, this Article does not treat these expenditures as business intangible capital.

[20] A question arises whether production period interest should be viewed as an intangible capital expenditure. Current law requires the capitalization of most production period interest related to tangible assets. *See* I.R.C. § 263A (West Supp. 1987). The underlying problem can be seen in a comparison of self-produced and purchased property. If one produces property to sell, one's price must include all outlays, including production period interest, in order to break even. The purchase price would therefore be expected to include these items (plus a possible profit for the builder). For this reason, when one self-produces property, the property also should be expected to increase in value not only by the amount of the direct expenditures, but also by at least the amount of production period interest.

Production period interest, however, does not stand on the same footing as other costs. This is because equity-financed property should experience the same value increase as debt-financed property. The market price will not vary depending on how the property is financed. There is an economic basis for this result. A rational equity-financed seller should get out of the property not only his costs, but also a return for what could have been earned if the funds tied up in production had been profitably invested. The same factor, the use of money during production, affects the equity-financed seller just as it affects the debt-financed seller. The debt-financed seller pays for the use of money by paying interest, while the equity-financed seller pays for the use of money by not earning a current return on its funds used in production. As a result, roughly parallel treatment of debt-financed and equity-financed self-production (in a world that treats production period interest as a cost of the property) would tax imputed lost interest (if equity-financed) and capitalize the imputed interest as a cost of the property. Exactly parallel treatment would allow the deduction of production period interest and both impute and capitalize lost interest on all production costs (because the imputed rate might be different than the rate on the borrowing that finances any production period interest). For this reason, it is not necessary to view production period interest as an intangible capital expenditure.

[21] The tax accounting method for determining when expenditures are taken into account is irrelevant for purposes of this Article. Consequently, this Article refers to expenditures "made" as a shorthand for referring to expenditures paid or incurred (accrued). The focus of this Article is on expenditures paid in one year that relate to taxable income in later years. It therefore deals with a problem that is the reverse of the mislabelled "premature accrual" problem—expenditures that relate to current taxable income but that are not paid until later years. *See* 1 SENATE COMM. ON FINANCE,

penditures on advertising, promotion, research and development ("R&D"), and employee recruitment, education, training, care, and retention. This Article tries to avoid distinguishing between intangible capital represented by something that can be viewed as an asset (like a patent) and other, non-asset, intangible capital (such as trained employees), as it argues that the asset notion[22] contributes to the problems in current law.

As so defined, in the abstract, intangible capital expenditures are economically similar to expenditures on tangible assets. A tangible asset has value only to the extent it is expected to generate future cash flow, either by being sold or by increasing future net cash flow.[23] In fact, one can look at the value of an asset as being the present value of the expected future cash flow.[24] Because receipt of the future cash flow is delayed, however, the cash flow must repay the expenditures plus an additional return to compensate for the delay. The return merely assures (i) that the present value of the future cash flow equals the amount of current expenditures and (ii) that the owner of the asset is compensated for the risk of receiving the cash flow. Expenditures on tangible assets therefore convert the cash expended into an expected stream of future net revenues that repay the expenditures plus a return.

Intangible capital is value in a business not attributable to tangible assets or cash equivalents. Such value is present only if the business is expected to generate net cash flow in the future in excess of a market return on the tangible assets, cash equivalents, future expenditures, future services, etc.[25] There are two ways intangible capital expenditures can contribute to future excess net cash flow.[26] First, the expenditures can result in increased future revenues. For example, advertising can increase future sales or increase the prices that can be charged. Second, expenditures can result in future cost savings that increase the future net cash flow of the business. R&D expenditures, for example, may result in a manufacturing procedure or employee know-how that

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98TH CONG., 2D SESS., EXPLANATION OF PROVISIONS APPROVED BY THE COMM. ON MARCH 21, 1984 264-67 (Comm. Print 1984) [hereinafter EXPLANATION OF PROVISIONS]. For a remarkably clear and insightful analysis of the economic issues involved in "premature accruals," referred to by the author more accurately as "reverse investments," see Kiefer, *The Tax Treatment of a "Reverse Investment"*, 26 TAX NOTES 925 (1985).

[22] A discussion of the asset and property notions as they inform our tax and other laws is well beyond the scope of this Article. For purposes of this Article, it is sufficient to view an asset as something that can be transferred for value.

[23] R. MILLER, INTERMEDIATE MACROECONOMICS 155 (1978).

[24] This result is assumed by most economists. 3 F. MACHLUP, KNOWLEDGE: ITS CREATION, DISTRIBUTION, AND ECONOMIC SIGNIFICANCE 403-18 (1984).

[25] Doernberg & Hall, *supra* note 2, at 366-69.

[26] Hirschey, *supra* note 1, at 376-77.

reduces energy costs, increasing the business's future profits. Intangible capital expenditures, like expenditures on tangible assets, therefore convert into the expectation of increased future net revenues that repay the expenditures plus a return. A prospective purchaser of the business should be willing to pay roughly as much for the business after the expenditures are made as before, because, although the expenditures are gone, future net revenues should be greater, compensating for the "lost" expenditures.

Many intangible capital and asset-related expenditures have another similarity: both "depreciate."[27] Depreciation is the loss in value over time of a business as a result of the effects of exhaustion, wear, tear, obsolescence, and the like on the business. A machine wears out or becomes obsolete. Patents exhaust over their seventeen-year legal life as the end of the life approaches. A trained workforce becomes less valuable as employees quit.

The existing scholarship focuses on three specific types of expenditures that contribute to intangible capital.[28] First, a number of studies find that some advertising increases intangible capital.[29] The economic evidence indicates that while much advertising may have short-lived economic effects,[30] other advertising may benefit the business for quite

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[27] For simplicity, this Article treats "amortization" as a form of "depreciation."

[28] *See* Brozen, *supra* note 1, at 7.

[29] *See* J. LAMBIN, ADVERTISING, COMPETITION AND MARKET CONDUCT IN OLIGOPOLY OVER TIME 90-100 (1976); K. PALDA, THE MEASUREMENT OF CUMULATIVE ADVERTISING EFFECTS 95 (1964); Abdel-khalik, *Advertising Effectiveness and Accounting Policy,* 50 ACCT. REV. 657, 657 (1975); Ben-Zion, *supra* note 1, at 227-28; Hirschey, *supra* note 1, at 375-78. Basically, there are two schools on how to view advertising. One school views advertising as an asset (i.e., paying only a market return), while the other views advertising as "better" than an asset (i.e., reducing competition in a market so that the advertising pays not only a market risk-adjusted return on investment but also a greater monopoly profit). *See, e.g.,* J. BACKMAN, ADVERTISING AND COMPETITION 155-57 (1967) (not clear); W. COMANOR & T. WILSON, *supra* note 16, at 238-53 (no monopoly); ECONOMISTS ADVISORY GROUP, THE ECONOMICS OF ADVERTISING 65 (1967) (no monopoly); J. LAMBIN, *supra,* at 166-68 (no monopoly); F. SCHERER, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE, 390-93 (2d ed. 1980) (monopoly, with reservations); R. SCHMALENSEE, THE ECONOMICS OF ADVERTISING 216-44 (1972) (not clear); Comanor & Wilson, *The Effect of Advertising on Competition: A Survey,* 17 J. ECON. LIT. 453, 470-73 (1979) [hereinafter Comanor & Wilson 1979] (monopoly); Telser, *Advertising and Competition,* 72 J. POL. ECON. 537, 538 (1964) (no monopoly). This dispute is not relevant for purposes of this Article. Both sides agree that advertising can increase future revenues. In other words, both sides apparently would agree that advertising can result in intangible capital. *See, e.g.,* Comanor & Wilson, *Advertising Market Structure and Performance,* 49 REV. ECON. & STATISTICS 423, 437 (1967).

[30] *See, e.g.,* Abdel-khalik, *supra* note 29, at 667; Comanor & Wilson 1979, *supra* note 29, at 464; Falk & Miller, *Amortization of Advertising Expenditures,* 15 J. ACCT. RES. 12, 21-22 (1977) (100% depreciation in one year from date when made, but not within calendar year made); Picconi, *A Reconsideration of the Recognition of Advertising Assets on Financial Statements,* 15 J. ACCT. RES. 317, 323 (1977) (service

some time.[31] For example, television advertising for consumer goods has been found to depreciate[32] only about 20% a year.[33] Cigarette advertising in general has been found to depreciate between 35% and 45% a year in one study,[34] and only 15% to 20% in another.[35] Advertising on "Lucky Strike" cigarettes (from 1926 to 1939) was found not only to depreciate, but also to provide a nominal[36] return[37] of approximately 15%.[38] One study of selected firms found food, drug, and cosmetic advertising to last approximately 5.5 years.[39] It is very difficult to generalize about the factors that influence the effect of advertising.[40] Its effects vary from firm to firm in a given industry.[41] Most agree, however, that

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life of advertising expenditures tended to expire within annual accounting period.). An important type of non-intangible capital advertising expenditure is the cost of "defensive" advertising. Defensive advertising merely prevents the business from losing sales as a result of competitors' advertising. It occurs in small markets, particularly oligopolies. Arguably, defensive advertising is socially wasteful as it does not contribute to economic activity (other than of advertising agencies, the media, etc.). *See* J. LAMBIN, *supra* note 29, at 107-09, 124-27; F. SCHERER, *supra* note 29, at 386-90; Dixit & Norman, *Advertising and Welfare,* 9 BELL J. ECON. 1, 9-13 (1978); Peles, *Econometric Measurement of the Duration of Advertising Effect on Sales: A Comment,* 16 J. MARKETING RES. 284, 284-85 (1979). There may be similar problems with R&D. *See* Grabowski & Mueller, *supra* note 1, at 338.

[31] *See* Grabowski, *The Effects of Advertising on the Interindustry Distribution of Demand,* 3 EXPLORATIONS ECON. RES. 21, 69-70 (1976) (suggesting that industries most benefited by advertising were those most suited to television advertising); Hirschey, *supra* note 1, at 386-87 (noting that television advertising tends to be long-lived).

[32] The studies, for the sake of convenience, generally assume that advertising depreciates in a "declining balance" fashion. *See, e.g,* Ben-Zion, *supra* note 1, at 225; Grabowski & Mueller, *supra* note 1, at 330. The same assumption is made in this Article. Declining balance depreciation provides that a fixed percentage of the value of an asset at the beginning of each year is lost each year. For example, if an asset cost $100, 20% declining balance depreciation would allow annual deductions of $20, 16, 12.8, 10.24, 8.19, 6.55, 5.24, 4.2, etc. Declining balance depreciation never ends, because in each year only a percentage of the remaining value is depreciated. In later years, however, the amount depreciated becomes insignificant.

[33] *See* Hirschey, *supra* note 1, at 387 (21.1%).

[34] *See* Peles, *Rates of Amortization of Advertising Expenditures,* 79 J. POL. ECON. 1032, 1052 (1971).

[35] *See* Telser, *Advertising and Cigarettes,* 70 J. POL. ECON. 471, 498 (1962).

[36] A "nominal" return is not adjusted for inflation, while a "real" return is.

[37] This Article is concerned only with the return to the business. One of the great questions with respect to much intangible capital is the relationship between this private rate of return and the social rate of return. *See, e.g.,* Mansfield, Rapoport, Romeo, Wagner & Beardsley, *Social and Private Rates of Return From Industrial Innovations,* 91 Q.J. ECON. 221, 221 (1977) (reporting the results of 17 case studies, each of which estimates the social and private rate of return from the investment in a particular industrial innovation).

[38] *See* Telser, *supra* note 35, at 483. Years 1929 through 1932 were omitted because of data problems. *Id.* at 482.

[39] *See* Abdel-khalik, *supra* note 29, at 663-64.

[40] *See* Hirschey & Weygandt, *Amortization Policy for Advertising and Research and Development Expenditures,* 23 J. ACCT. RES. 326, 333 (1985).

[41] *See supra* notes 30-31 and accompanying text.

institutional goodwill advertising[42] and advertising on nondurable consumer goods[43] are likely to increase intangible capital. Second, various studies have concluded that research and development expenditures contribute to intangible capital.[44] The economic life of R&D appears to be less variable than the life of advertising.[45] In four different studies, R&D expenditures have been found to depreciate at an annual rate of (i) approximately 25%,[46] (ii) 15% on average,[47] (iii) between 18% and 36%,[48] and (iv) approximately 20%.[49] A fair amount of work has been

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[42] *See* Kuehn, *How Advertising Performance Depends on Other Marketing Factors,* 2 J. ADVERTISING RES. 2, 3 (1962) (not based on empirical work).

[43] *See* Grabowski, *supra* note 31, at 61; Hirschey & Weygandt, *supra* note 40, at 333; *cf.* Porter, *Consumer Behavior, Retailer Power and Market Performance in Consumer Goods Industries,* 56 REV. ECON. & STATISTICS 419, 430 (1974) (retail channels affect consumer demand).

[44] *See, e.g.,* Ben-Zion, *supra* note 1, at 228; Ben-Zion, *The R&D and Investment Decision and Its Relationship to the Firm's Market Value: Some Preliminary Results,* in R&D, PATENTS, AND PRODUCTIVITY 299, 308 (Z. Griliches ed. 1984); Connolly & Hirschey, *R&D, Market Structure and Profits: A Value-Based Approach,* 66 REV. ECON. & STATISTICS 682, 686 (1984); Grabowski & Mueller, *supra* note 1, at 342; Griliches, *Market Value, R&D, and Patents,* in R&D, PATENTS, AND PRODUCTIVITY *supra,* at 249, 250; Pakes, *On Patents, R&D, and the Stock Market Rate of Return,* 93 J. POL. ECON. 390, 401 (1985).

[45] *See* Grabowski & Mueller, *supra* note 1, at 328-29; Hirschey, *supra* note 1, at 386-87 . Studies of the relationship between R&D and the value of the firm have noted an interesting effect. The market value appears to be affected only by unexpected changes in R&D. *See* Griliches, *supra* note 44, at 252; Pakes, *supra* note 44, at 406. A 1% unexpected increase in R&D was found to increase the value of the firm 0.39%. *See* Pakes, *supra* note 44, at 402. Another study found a $2 increase in value from a $1 increase in R&D. *See* Griliches, *supra* note 44, at 250. Similar results were obtained in Ben-Zion, *supra* note 44, at 308. The studies speculate that R&D increases when there is a discovery, which discovery also increases the firm's value, so that there is no cause and effect relationship between expenditures and value. *See* Griliches, *supra* note 44, at 252; Pakes, *supra* note 44, at 407. For this reason, these studies, other than confirming that R&D probably results in intangible capital, are not helpful for evaluating the specific relationship between expenditures and value. Many of the R&D studies present similar "chicken or egg" problems. It is not clear whether the R&D causes the associated increased profits and value or vice versa. *See* Baily, *Research and Development Costs and Returns: The U.S. Pharmaceutical Industry,* 80 J. POL. ECON. 70, 83-84 (1972). One study has concluded that R&D causes profitability and not vice versa. *See* Branch, *Research and Development Activity and Profitability: A Distributed Lag Analysis,* 82 J. POL. ECON. 999, 1008-11 (1974). An analogous problem might be present with advertising, but J. LAMBIN, *supra* note 29, at 132-34, concludes otherwise.

[46] *See* Hirschey, *supra* note 1, at 386.

[47] *See* E. MANSFIELD, INDUSTRIAL RESEARCH AND TECHNOLOGICAL INNOVATION—AN ECONOMETRIC ANALYSIS 79 (1968).

[48] *See* Pakes & Schankerman, *The Rate of Obsolescence of Patents, Research Gestation Lags, and the Private Rate of Return to Research Resources,* in R&D, PATENTS, AND PRODUCTIVITY *supra* note 44, at 73, 80.

[49] Ben-Zion, *supra* note 1, at 228.

This Article is concerned only with the decay of the value of intangible capital to the owning businesses. This is a somewhat different issue from the depreciation of the social value of the total stock of R&D, *see, e.g.,* 3 F. MACHLUP, *supra* note 24, at 555-

done on the return on investment in R&D. One of these studies found a nominal return of approximately 12%, with research intensive firms earning 15% to 20%.[50] Another study found real returns from 7.5% to 17.4%.[51] The most ambitious study found real returns varying from negative for research on an electronic device (the investment did not pay back the expenditures, which can happen with any risky investment), to 214%, for research that developed a household cleaning device, with most in the 15% to 50% range.[52] An historical study found real returns of approximately 35% for 1954, declining evenly to 25% in 1961.[53] Another found nominal returns of approximately 11% to 18% in 1960 and approximately 3% to 6% in 1973.[54] Other works suggest that returns are declining.[55]

Third, there is some work that concludes, on the basis of indirect evidence, that expenditures for improving the production or other useful attributes of employees—expenditures on recruiting, selecting, training, health care, morale, retention, etc. (which can be viewed as expenditures on the business's "human capital")—contribute to a business's intangible capital.[56] A large body of literature investigates individuals' investments in themselves, particularly through education and on-the-job training. This work generally concludes that individuals' educational investments (cost plus lost income while in school) pay for themselves (plus a return) through higher future wages.[57] Similarly,

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56, and from the lagged effect of advertising on sales, *see, e.g.*, Clarke, *Econometric Measurement of the Duration of Advertising Effect on Sales,* 13 J. MARKETING RES. 345 (1976).

[50] Grabowski & Mueller, *supra* note 1, at 336-37, 342.

[51] Pakes & Schankerman, *supra* note 48, at 85.

[52] Mansfield, Rapoport, Romeo, Wagner & Beardsley, *supra* note 37, at 233.

[53] Baily, *supra* note 45, at 82.

[54] *See* D. SCHWARTZMAN, THE EXPECTED RETURN FROM PHARMACEUTICAL RESEARCH 36, 44 (1975).

[55] *See* H. GRABOWSKI, DRUG REGULATION AND INNOVATION: EMPIRICAL EVIDENCE AND POLICY OPTIONS 54 (1976). This may be because only less risky (and therefore lower yielding) projects are being undertaken. A concern that only low-risk R&D was being done was the basis for the research and experimentation credit enacted in 1981, discussed *infra* text accompanying notes 276-79, 343-45. *See* S. REP. No. 144, 97th Cong., 1st Sess. 76-77 (1981). None of these studies involve years subject to the credit.

[56] G. BECKER, *supra* note 1, at 15-44.

[57] *See, e.g.*, G. BECKER, *supra* note 1, at 147-237; Blaug, *The Empirical Status of Human Capital Theory: A Slightly Jaundiced Survey,* 14 J. ECON. LIT. 827, 840 (1976); Garen, *The Trade-Off Between Wages and Wage Growth,* 20 J. HUM. RESOURCES 522, 538 (1985). Kiker and Roberts, in *The Durability of Human Capital: Some New Evidence,* 22 ECON. INQUIRY 269, 279-80 (1984), find that job interruption results in extraordinary drops in the value of human capital. From this the authors conclude that human capital is short-lived and requires substantial "repairs" to maintain value. An alternative conclusion is that letting human capital lie unused results in greater depreciation, much as happens to a machine that is left unused and allowed to

the literature concludes that individuals invest in their own on-the-job training by accepting lower wages in jobs that provide training.[58] Most studies find that such individuals' investments in their training also pay back the investment plus a return.[59] For example, one study found nominal returns between 9% and 12.7%,[60] while another found that one dollar of training results in twelve cents increased earnings per year over the remaining working career.[61] The underlying economic models suggest that businesses should invest in their employees and that the investment should repay that investment plus a return to the business.[62] For example, the problem that employees can quit, destroying

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rust, etc.

[58] *See* G. BECKER, *supra* note 1, at 16-37; Rosen, *Learning and Experience in the Labor Market,* 7 J. HUM. RESOURCES 326, 327-29 (1972).

[59] *See* J. MINCER, SCHOOLING, EXPERIENCE, AND EARNINGS 93-94 (1974) (returns on education plus training); Duncan & Hoffman, *On-the-Job Training and Earnings Differences by Race and Sex,* 61 REV. ECON. & STATISTICS 594, 601-02 (1979). One related issue that has received considerable attention is whether human capital (primarily education and on-the-job training) explains inequality of earnings—higher earnings of some merely representing a return on investment. *See, e.g.,* Hancock & Richardson, *Discount Rates and the Distribution of Lifetime Earnings,* 20 J. HUM. RESOURCES 346, 356 (1985) (Uncertainty remains about the extent to which return of investment explains differences in current earnings.). Minorities and interrupted careers (primarily women) have presented real problems for the human capital theory explaining apparent inequality. *See, e.g.,* Hanushek & Quigley, *Life-Cycle Earning Capacity and the OJT Investment Model,* 26 INT'L ECON. REV. 365, 381-83 (1985) (suggesting that non-investment models of life-cycle variations in earnings be analyzed in order to understand inequality of wage growth across race or gender groups). Even those who believe that human capital theory does not explain inequality, however, recognize that some expenditures and lost income have capital characteristics (although those expenditures may be race or sex limited), which represents the only conclusion needed for purposes of this Article. Bartel & Lichtenberg, in *The Comparative Advantage of Educated Workers in Implementing New Technology: Some Empirical Evidence,* National Bureau of Economic Research Working Paper No. 1718 (1985), reach the conclusion that employee education demonstrates more characteristics of human capital the more technologically sophisticated the work place. Consequently, there may be symbiosis between types of intangible capital.

[60] *See* Mincer, *On-The-Job Training: Costs, Returns, and Some Implications,* 70 J. POL. ECON. 50, 56 (Supp. 1962).

[61] *See* Rosen, *Taxation and On-The-Job Training Decisions,* 64 REV. ECON. & STATISTICS 442, 446-47 (1982).

[62] *See supra* note 58 and accompanying text. Education and training are not the only aspects of employer investment in employee-related human capital. Employers also can invest in employee mental and physical health. *See* G. BECKER, *supra* note 1, at 41. There is a large body of literature on the economics of employees investing in their own health, particularly health insurance. *See* Grossman, *On the Concept of Health Capital and the Demand for Health,* 80 J. POL. ECON. 223, 246-48 (1972); Pauly, *Taxation, Health Insurance, and Market Failure in the Medical Economy,* 24 J. ECON. LIT. 629 (1986). This literature is less helpful than, for example, the literature on employee training, since most employer-provided health care probably benefits principally the employees (and not the employer), while much employer-provided training (that is not transferable to other employers) benefits employers. Also, employer investment in health probably is quite small. *See* G. BECKER, *supra* note 1, at 41.

the business's investment, is reduced by observing that in these cases the employer will pay a higher wage (but not higher than the value of the investment) to retain the investment.[63] There is no empirical work, however, that verifies the intangible capital result for employer investments in their employees or that indicates depreciation patterns or rates of return.

The literature has focused on these types of expenditures because data is available, not because of a judgment that these are the only types of intangible capital expenditures.[64] For example, while non-advertising promotional expenditures, like salesmen's salaries, probably result in intangible capital,[65] there is no empirical work on these expenditures.

Despite the economic similarity between intangible capital expenditures and expenditures with respect to assets, current tax law provides different treatment for many intangible capital expenditures than for expenditures on economically similar tangible assets. It also treats intangible capital expenditures differently in three situations: (1) allowing a deduction for many when incurred by a going concern,[66] (2) allowing practically no deduction at all when incurred in the acquisition of a business,[67] and (3) allowing 60-month depreciation when incurred by a start-up business.[68] This inconsistent regime is the source of the three following equity and neutrality problems.

C. *Implicit Preference for Much Intangible Capital*

1. Applicable Law

The first problem, an implicit preference for many intangible capital expenditures, results from the current rules that determine the tax treatment of expenditures at the time made. Current law in general

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[63] *See* G. BECKER, *supra* note 1, at 31-32.

[64] *See, e.g.,* J. SIMON, *supra* note 17, at xv; Weiss, *Advertising, Profits, and Corporate Taxes,* 51 REV. ECON. & STATISTICS 421, 421 n.1 (1969).

[65] *See* J. SIMON, *supra* note 17, at xv; Grabowski & Mueller, *supra* note 1, at 334.

[66] I.R.C. § 162 (1982 & Supp. III 1985 & West Supp. 1987). *See infra* notes 69-107, 224-38 and accompanying text.

[67] Treas. Reg. §§ 1.263(a)-1(a) (as amended in 1965) (capital expenditures in general), 1.461-1(a) (as amended in 1967) ("If an expenditure results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year such an expenditure may not be deductible . . . ."). *See infra* notes 139-65, 248-56.

[68] I.R.C. § 195(b)(1) (1982 & Supp. III 1985); *see infra* notes 175-83 and accompanying text.

allows an immediate deduction for business expenses.[69] No deduction is allowed, however, for the costs of purchased assets[70] or for expenditures incurred in connection with the self-construction or improvement of non-inventory[71] assets.[72] These expenditures, which are "capitalized" as costs of the assets, may be deducted subsequently. For example, the costs of qualified "depreciable" business assets are deductible over time through a depreciation allowance.[73] Depreciation deductions are allowed so that, as the depreciable asset is expected to lose value over time, the expected value loss is treated like an expense.[74] The capitalized costs of most tangible assets used in business are allowed as depreciation deductions.[75] In contrast, many expenditures related to intangible value are immediately deducted as business expenses.

These rules in effect provide more generous treatment for many expenditures related to intangible capital than for economically similar expenditures related to tangible assets. This difference can be quite important. Consider an example: A taxpayer has $1,000 to use in its business. It is considering two uses, buying television advertising or buying a new manufacturing machine. The two uses of $1,000 are equally

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[69] I.R.C. § 162 (1982 & Supp. III 1985 & West Supp. 1987).

[70] I.R.C. § 263 (1982 & Supp. III 1985 & West Supp. 1987). *See infra* notes 199-201 and accompanying text.

[71] Special rules provide similar treatment for expenditures with respect to inventory. I.R.C. §§ 263A(a) (West Supp. 1987), 471 (1982 & West Supp. 1987); Treas. Reg. §§ 1.471-1 (1960) to 1.472-8 (as amended 1982). Because intangible capital generally is more similar to non-inventory assets than to inventory, this Article focuses on the general capitalization rules.

[72] I.R.C.§§ 263(a)(1) (1982 & Supp. III 1985 & West Supp. 1987), 263A(b) (West Supp. 1987). This is an oversimplification of current law. *See infra* text accompanying notes 192-217.

[73] I.R.C. § 167(a) (1982 & Supp. III 1985 & West Supp. 1987). If a business asset is abandoned, destroyed, becomes worthless, or (for depreciable property) retired at a time when all of the capitalized costs have not been allowed as depreciation deductions (i.e., when the taxpayer still has a positive adjusted basis), the adjusted basis is allowed as a loss deduction or as a final depreciation deduction (reduced by residual value in the case of retirements). I.R.C. § 165 (1982 & Supp. III 1985 & West Supp. 1987); Treas. Reg. § 1.167(a)-8 (as amended 1977) (gains and losses on retirements); Prop. Treas. Reg. § 1.168-6(a)(3), 49 Fed. Reg. 5970-71 (1984); *see also* B. BITTKER, *supra* note 2, at ¶ 23.8 (discussing Treasury Regulations that govern the treatment of depreciable assets withdrawn from service).

[74] *See* Treas. Reg. § 1.167(a)-1 (as amended in 1972) (deduction for expected loss in value); Commissioner v. Idaho Power Co., 418 U.S. 1, 10-12 (1974) (purpose of depreciation accounting for tangible assets is to allocate the assets' costs to periods benefited by the assets' physical consumption); *see also* OFFICE OF THE SECRETARY, U.S. DEPARTMENT OF THE TREASURY, BLUEPRINTS FOR BASIC TAX REFORM, 64-67 (1977) [hereinafter BLUEPRINTS]. There are other views of depreciation. *See* J. DODGE, CASES AND MATERIALS ON FEDERAL INCOME TAXATION: PRINCIPLES, POLICY, PLANNING 507-08 (1985) (discussing other theories of capital recovery). These views are less consistent with the neutrality criterion. *See infra* note 79.

[75] I.R.C. § 167(a) (1982 & Supp. III 1985 & West Supp. 1987).

attractive economically. Both will increase the business's income by $263.80 per year over the next five years (and have no effect or value after five years). This cash flow returns the $1,000 plus pays a 10% compounded annually before-tax return on the balance of the $1,000 not recovered.[76] The taxpayer is in the 35% tax bracket. Compare the tax results with immediate deduction and pro rata (straight-line) depreciation over five years:

Table I

	Income	Deduction	Tax	Net Cash	Prsnt Val[77]
Immediate Deduction					
Year 1	263.80	1,000	-257.67	521.47	489.64
Year 2	263.80	-0-	92.33	171.47	151.18
Year 3	263.80	-0-	92.33	171.47	142.95
Year 4	263.80	-0-	92.33	171.47	133.29
Year 5	263.80	-0-	92.33	171.47	125.15
				1,207.35	1,042.21
Pro-Rata Depreciation					
Year 1	263.80	200	22.33	241.57	226.73
Year 2	263.80	200	22.33	241.47	212.89
Year 3	263.80	200	22.33	241.47	199.90
Year 4	263.80	200	22.33	241.47	189.70
Year 5	263.80	200	22.33	241.47	176.24
				1,207.35	1,003.46[78]

Immediate deduction (100% first year depreciation) provides earlier, and, therefore, more valuable in present value terms, tax deductions, resulting in a larger present value after-tax cash flow. If the advertising is deducted immediately and the machine is limited to depreciation, the advertising gets a tax preference. Although the advertising and the machine provide identical before-tax returns, immediate deduction would

[76] The discussion assumes that the cash flows are risk-free. If the cash flows are subject to differing levels of risk, for the two uses of funds to be equally economically attractive, the relative returns (and cash flows) should change to reflect the differing risk.

[77] The after-tax cash flow is discounted using a 6.5% compounded annually after-tax discount rate.

[78] The asset is "worth" somewhat more than its cost because pro rata tax depreciation is somewhat accelerated compared to depreciation for the actual annual loss in value (economic depreciation). *See* M. CHIRELSTEIN, FEDERAL INCOME TAXATION 130-35 (4th ed. 1985). This error is sufficiently small, however, that it does not seem worthwhile to abandon the simplicity of pro rata depreciation.

make the advertising more attractive, after taxes, than the machine.[79]

Two basic problems arise when making the important distinction between immediately deductible expenses and capital expenditures with respect to intangible capital: (i) determining what is an intangible asset and (ii) deciding whether an expenditure is sufficiently related to an intangible asset that the expenditure must be capitalized as a cost of the asset. These two problems become so intertwined, however, that the two problems must be discussed together.

The current law has most often drawn the line between immediately deductible expenses and capital expenditures (the "asset-capitalized" rules)[80] with respect to intangibles in cases and rulings.[81] This law is remarkably confused, as the Eleventh Circuit has observed:

> The proper line between deduction and capitalization . . . [is] difficult to draw when the long-lived benefit achieved as the result of an expenditure is not a tangible asset or a readily identifiable intangible asset. . . . That problem has received a great deal of judicial attention, with results that are not entirely consistent.[82]

The contrasting treatment in two recent cases presents an excellent example of the confusion. In the first, the Fourth Circuit allowed a financial institution to deduct the costs of marketing surveys undertaken in order to plan new branches.[83] In the second, the Fifth Circuit disallowed a similar deduction.[84] To the Fourth Circuit, there is no asset created by marketing surveys.[85] The Fourth Circuit opinion is in line with a series of cases holding that banks' expenditures in beginning

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[79] *See* Samuelson, *Tax Deductibility of Economic Depreciation to Insure Invariant Valuations,* 72 J. POL. ECON. 604, 604-05 (1964) (demonstrating that under the assumption that the taxpayer's tax rate does not change over the life of an asset, only economic depreciation assures that, if one asset has a higher before-tax return than another, the after-tax return of the first asset will be greater than the after-tax return of the second). The text applies this result to asset-like intangible capital.

[80] This Article draws a distinction between "asset-capitalized" expenditures and "asset-related" expenditures. *See supra* notes 192-94 and accompanying text. "Asset-related" expenditures are any expenditures that increase the value of a business's non-cash equivalent assets. "Asset-capitalized" expenditures are expenditures treated as asset-related for tax purposes.

[81] *See* B. BITTKER, *supra* note 2, at ¶ 20.4.4 (discussing cases and rulings regarding the capitalization of intangibles-related expenditures).

[82] Ellis Banking Corp. v. Commissioner, 688 F.2d 1376, 1379 n.7 (11th Cir. 1982), *cert. denied,* 463 U.S. 1207 (1983).

[83] NCNB Corp. v. United States, 684 F.2d 285, 293-94 (4th Cir. 1982).

[84] Central Tex. Sav. & Loan Ass'n v. United States, 731 F.2d 1181, 1185 (5th Cir. 1984).

[85] *See NCNB Corp.,* 684 F.2d at 290-91 (The Fourth Circuit did not consider the marketing survey expense a capital cost because it did not meet the "separate and distinct additional asset" test.).

credit card services are deductible.[86] In contrast, the Fifth Circuit views marketing surveys as costs of the "branch," a valuable intangible asset separate from the tangible assets located at the branch.[87]

The taxation of advertising reflects similar anomalies. One early case held that successful advertising to acquire new customers creates assets:

> [I]t is clear that there was both an expenditure of a large amount of money, and the acquirement of something of permanent use or value in the business. The taxpayer here admits the expenditure of money, but denies the acquisition of anything of permanent use or value in its business. The answer to that contention is that the corporation acquired (1) . . . new customers, and (2) goodwill, and (3) elimination of competition.[88]

Other cases note that advertising (or at least increased advertising) can be capital, but allow a deduction for all advertising because of the difficulty in determining what portion of total advertising should be capitalized.[89] As the Board of Tax Appeals noted in one of these cases:

> Briefly summarized, petitioner's contentions are that the expenditure for advertising . . . was made during the first year of its existence; that the amount spent for this purpose was abnormally large because of the fact that it was seeking to establish a market for its product and that it should be permitted to take deductions over a series of years for this abnormal and unusual expense in order that the subsequent years which received the benefit of the advertising might bear their proportionate part of the cost thereof. . . . And we may add that with the principles asserted we are in entire accord. The difficulty presented is in the application of

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[86] *See, e.g.,* First Sec. Bank of Idaho v. Commissioner, 592 F.2d 1050, 1052 (9th Cir. 1979); Iowa-Des Moines Nat'l Bank v. Commissioner, 592 F.2d 433, 436 (8th Cir. 1979); First Nat'l Bank of S.C. v. United States, 558 F.2d 721, 723 (4th Cir. 1977); Colorado Springs Nat'l Bank v. United States, 505 F.2d 1185, 1193 (10th Cir. 1974).

[87] *See Central Tex. Sav. & Loan,* 731 F.2d at 1185. The I.R.S. appears to be equally confused. *See* Wabich, *Expenses Relating to Abandoned Acquisitions and Business Expansion: Capital v. Ordinary,* 64 TAXES 377, 380 (1986) (comparing private letter rulings, which reflect a similarly inconsistent analysis).

[88] Houston Natural Gas Corp. v. Commissioner, 90 F.2d 814, 816 (4th Cir.), *cert. denied,* 302 U.S. 722 (1937).

[89] *See, e.g.,* Colonial Ice Cream Co. v. Commissioner, 7 B.T.A. 154, 156-58 (1927).

these principles to the facts before us.[90]

Notwithstanding, the I.R.S. generally does not challenge advertising deductions.[91] It appears that the courts are adopting this view.[92]

Some early cases held that expenditures by periodicals to acquire subscribers, including advertising, must be capitalized as a cost of "circulation," an intangible asset.[93] In 1950, a special statutory provision allowing an immediate deduction for such circulation expenditures regardless of the general asset-capitalized rules was enacted to eliminate the uncertainty created by the cases.[94] Nevertheless, one case held that advertising to allay the public's fear of nuclear power so as to expedite receiving an operating permit for a nuclear power plant must be

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[90] *Colonial Ice Cream Co.*, 7 B.T.A. at 156. For an examination of why the taxpayer argued for capitalization, see *infra* text accompanying notes 241-45.

[91] *See* Treas. Reg. §§ 1.162-1(a) (1960), -20(a)(2) (1965) (goodwill advertising is generally deductible); Rev. Rul. 68-561, 1968-2 C.B. 117, 119; *see also* B. BITTKER, *supra* note 2, at ¶ 20.4.5 (Advertising expenses generally are deductible, assuming a sufficient nexus between the expenditure and the taxpayer's business.).

[92] *See, e.g.*, Cleveland Elec. Illuminating Co. v. United States, 7 Cl. Ct. 220, 231 (1985) (stating that "[e]xpenditure[s] for institutional or 'goodwill' advertising are generally deductible as ordinary and necessary business expenses"); Consolidated Apparel Co. v. Commissioner, 17 T.C. 1570, 1582 (1952) ("Reasonable costs of advertising are generally allowable as business expenses."), *rev'd in part on other grounds*, 207 F.2d 580 (7th Cir. 1953).

[93] *See, e.g.*, Public Opinion Publishing Co. v. Jensen, 76 F.2d 494, 496 (8th Cir. 1935) ("The circulation of a publication is a capital asset, and money expended in increasing it is a 'capital expenditure' and is not deductible in determining the publisher's taxable income."); Meredith Publishing Co. v. Commissioner, 64 F.2d 890, 891 (8th Cir.) ("[M]oney expended in building up circulation structure is a capital expenditure" because a magazine's circulation is an intangible capital asset.), *cert. denied*, 790 U.S. 646 (1933); Strong Publishing Co. v. Commissioner, 56 F.2d 550, 552 (7th Cir. 1932) (stating that monies used to increase circulation of a publication are capital expenditures).

[94] Revenue Act of 1950, Pub. L. No. 81-814, 64 Stat. 906, 929 (1950) (codified as amended at I.R.C. § 173 (1982 & Supp. III 1985 & West Supp. 1987)); S. REP. NO. 2375, 81st Cong., 2d Sess. 63-64 (1950). Current law provides an alternative minimum tax on taxpayers that benefit from tax preferences. The tax basically is 20% (21% for individuals) of alternative minimum taxable income less exemption amounts. *See* I.R.C. § 55 (West Supp. 1987). The tax applies when it exceeds the regular income tax. I.R.C. § 55(a) (West Supp. 1987). Alternative minimum taxable income basically is regular taxable income increased to reflect certain tax preferences. *See* I.R.C. § 55(b)(2) (1982 & West Supp. 1987). Section 56(b)(2) provides that, in the case of individuals, circulation expenditures described in section 173 must be depreciated over three years for minimum tax purposes. *See* I.R.C. § 56(b)(2)(A)(i) (West Supp. 1987). This preference treatment is questionable given that section 173 was not enacted for a preferential purpose. In the case of corporations, circulation expenditures may increase the preference item for 50% of the difference between book income and alternative minimum taxable income (75% of the difference between earnings and profits [a tax term of art] and alternative minimum taxable income, after 1989). *See* I.R.C. § 56(c)(1), (f), (g) (West Supp. 1987). A corporation may elect three-year depreciation in lieu of this treatment. *See* I.R.C. § 59(e)(1) (West Supp. 1987).

treated as a capital cost of the permit, an intangible asset.[95]

The law on non-advertising promotional expenditures is even more confused. Cases and rulings go both ways with respect to the deduction of the costs of catalogues distributed to customers[96] and of expenditures for promotional gifts.[97] One case held that free samples must be capitalized.[98] In a revenue ruling, the I.R.S. held that, while a utility's advertising to promote sales is deductible, cash incentives to new customers are a capital cost of acquiring the customers, an intangible asset.[99] A highly publicized private ruling held that the cost of designing the "L'Eggs" package must be capitalized.[100]

Similar confusion is present in the law applicable to other intangible capital expenditures. A few early cases suggest that some R&D expenditures must be capitalized.[101] Following the precedent of periodicals' circulation expenditures, Congress enacted a special statutory provision[102] allowing an immediate deduction for certain "research or experimental" expenditures in part to reduce the uncertainty created by these cases.[103] The law dealing with similar costs outside the scope of

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[95] *Cleveland Elec.,* 7 Cl. Ct. at 231-33.

[96] *Compare* E.H. Sheldon & Co. v. Commissioner, 214 F.2d 655, 659, 661 (6th Cir. 1954) (deductible) *with* Best Lock Corp. v. Commissioner, 31 T.C. 1217, 1235 (1959) (capitalized) *and* Rev. Rul. 68-360, 1968-2 C.B. 197, 197 (capitalized).

[97] *Compare* Poletti v. Commissioner, 330 F.2d 818, 821-23 (8th Cir. 1964) (deductible, capitalization issue apparently not litigated) *with* Liberty Ins. Bank v. Commissioner, 14 B.T.A. 1428, 1435 (1929) (capitalized), *rev'd on other grounds,* 59 F.2d 320 (6th Cir. 1932).

[98] Durovic v. Commissioner, 542 F.2d 1328, 1334 (7th Cir. 1976) (no reasonably ascertainable useful life of free samples).

[99] Rev. Rul. 68-561, 1968-2 C.B. 117, 118 (Cash allowances to builders, contractors, and owners of buildings to encourage use of natural gas and other expenses of campaign are capital in nature.).

[100] Tech. Adv. Mem. 8,611,005 (March 5, 1986) (Package design costs were identifiable intangible assets with useful lives in excess of the taxable year and had to be capitalized.); *see* Roberts & McCarthy, *Capitalization of Package Design Costs: Critical Analysis and Proposal for Relief,* 38 TAX EXECUTIVE 309, 309 (1986) (critical of the I.R.S.'s decision and offering a proposal for taxpayer relief); Wall St. J., April 16, 1986, at 1, col. 5.

[101] *See e.g.,* Claude Neon Lights, Inc. v. Commissioner, 35 B.T.A. 424, 442 (1937) (requiring capitalization for research expenditures designed to improve taxpayer's product and to develop new product ideas). *See generally* Rice, *Research and Development Costs,* 25 TAXES 41 (1947) (a good discussion of pre-§ 174 law).

[102] Revenue Act of 1954, Pub. L. No. 83-591, § 174(b), 68A Stat. 1, 66-67 (codified as amended at I.R.C. § 174(b) (1982 & West Supp. 1987)).

[103] *See* S. REP. No. 1622, 83d Cong., 2d Sess. 33 (1954); H.R. REP. No. 1337, 83d Cong., 2d Sess. 28 (1954). Section 56(b)(2) provides that individuals must depreciate research or experimental expenditures subject to section 174 over 10 years for purposes of the alternative minimum tax. I.R.C. § 56(b)(2)(A)(ii) (West Supp. 1987). Much like with circulation expenditures, preference treatment may be wrong given that section 174 was not enacted exclusively for preferential proposes. Corporations may elect 10-year depreciation. I.R.C. § 59(e)(1), (2)(B) (West Supp. 1987).

the special statute is unclear. For example, the I.R.S. allows an immediate deduction for the costs of developing computer software regardless of whether the costs are "research or experimental" expenditures.[104]

Human capital expenditures generally are deductible.[105] One case, however, held that the costs of training employees at a new plant are a nondeductible cost of the new plant.[106] Another held that the cost of a fund established to make loans to employees so as to increase employee goodwill was nondeductible.[107]

2. The Problem

a. Current Law's Significant Implicit Preference

The law concerning capital expenditures is complicated and confused. The net result, however, is generous deductibility of many intangible capital expenditures compared to the less advantageous treatment of many economically similar asset-capitalized expenditures. The effect is an implicit preference for the intangible capital created by deductible expenditures ("preferred" intangible capital).[108]

There is evidence that the implicit preference for preferred intangible capital may be quite significant. As discussed below,[109] financial accounting generally requires that expenditures for advertising and R&D must be deducted immediately. There is evidence that this treatment results in substantial variations in the financial accounting profits of ongoing businesses compared to a regime that treats intangible capital similarly to other investments.[110] The size of the variations differs from industry to industry and from firm to firm.[111] These variations

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[104] *See* I.R.S. News Release IR-83-71 (April 19, 1983) (reaffirming Rev. Proc. 69-21, 1969-2 C.B. 303, § 3, which allows the deduction). It seems likely that the uncertainty that would result from trying to capitalize and depreciate software costs was a factor in the 1983 decision to continue the 1969 practice.

[105] *See* Cleveland Elec. Illuminating Co. v. United States, 7 Cl. Ct. 220, 234 (1985); Tech. Adv. Mem. 8,303,012 (Oct. 7, 1982).

[106] *Cleveland Elec.,* 7 Cl. Ct. at 227-30.

[107] Robertson v. Steele's Mills, 172 F.2d 817, 820-22 (4th Cir.), *cert. denied,* 338 U.S. 848 (1949). This case seems to be consistent with subsequent authority discussed *infra* text accompanying notes 224-35.

[108] *See* Weiss, *supra* note 64, at 426.

[109] *See infra* text accompanying notes 316-17.

[110] *See* K. CLARKSON, *supra* note 1, at 33-34; Bloch, *Advertising and Profitability: A Reappraisal,* 82 J. POL. ECON. 267, 283 (1974); Reekie & Bhoyrub, *Profitability and Intangible Assets: Another Look at Advertising and Entry Barriers,* 13 APPLIED ECON. 99, 107 (1981).

[111] *See* K. CLARKSON, *supra* note 1, at 59; Weiss, *supra* note 64, at 426-30. These studies assume crude estimates for depreciating advertising and R&D and therefore basically conclude that since advertising and R&D levels vary, the effects of capitalization vary, hardly a surprising result. An additional basis for the conclusion in the

are significant in dollar amount.[112] For example, in 1983, taxable U.S. corporations spent approximately $72 billion on advertising and $29 billion on R&D.[113]

One caveat must be noted. It is possible to view the special statutory deductions for research or experimental expenditures and for circulation expenditures, discussed above,[114] as explicit preferences. In this case, it is inappropriate to consider their effect along with the effects of the more general rules not intended to prefer certain types of assets or activities. Ignoring the two special provisions, one can still conclude that there is a large implicit preference, however, because, as noted above,[115] many amounts covered by the special provisions would be deductible under the general asset-capitalized rules in any event. Whether or not one views the special provisions as explicit preferences, there is a significant implicit preference for preferred intangible capital.

It can be argued that the implicit preference is not material. Businesses are allowed excess deductions for current preferred intangible capital expenditures, but are permitted no deduction for depreciation of past preferred intangible capital expenditures.[116] A regime that treats preferred intangible capital similarly to asset-capitalized expenditures would allow depreciation deductions. Consequently, the amount of over-deduction (compared to asset-capitalized treatment) in a given year may be relatively small, as the understated depreciation could well equal the overstated deduction for current expenditures.[117] Moreover, the businesses most likely to have small depreciation deductions, so that an immediate deduction for current expenditures is likely to exceed the depreciation deduction under asset-capitalized treatment, are start-up businesses, and, as discussed below,[118] start-up businesses do not get a current deduction.

This argument proves too much, as it also would suggest that the cost of depreciable tangible assets could be immediately deductible with little tax effect. In fact, the current treatment of assets subject to accel-

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text can be reached by looking at the evidence, discussed *supra* text accompanying notes 33-44, of the varying effects of advertising to businesses with the same levels of advertising.

[112] *See* Abdel-khalik, *supra* note 29, at 667; Bloch, *supra* note 110, at 284.

[113] INTERNAL REVENUE SERVICE, STATISTICS OF INCOME—1983 CORPORATION INCOME TAX RETURNS 22, 61 (1986).

[114] *See supra* text accompanying notes 94, 102-03.

[115] *See id.*

[116] *See supra* notes 69-107 and accompanying text (discussing different treatment of intangible expenditures).

[117] *Cf.* Swales, *Advertising as an Intangible Asset: Profitability and Entry Barriers,* 17 APPLIED ECON. 603, 607-10 (1985) (Advertising fluctuations are the key to understanding the effect of expensing on financial profits.).

[118] *See infra* text accompanying notes 175-81.

erated depreciation (which is less generous than an immediate deduction[119]) is estimated to cost approximately $38 billion a year compared to depreciation that approximates the actual decay in the value of depreciable assets.[120] The economic evidence of the extent of the intangible capital preference, noted above,[121] also suggests that this argument is in error.

The argument that immediate deductibility is not significant fails to take into account the magnitude of the difference between immediate deduction and depreciation.[122] Except under unusual circumstances, whenever an ongoing business increases preferred intangible capital expenditures, immediate deduction results in greater deductions than if depreciation were taken into account.

Not all deductions for employer-provided human capital represent a preference for employer investments in human capital. As noted above, many employees who benefit from employer-provided training in effect finance some or all of the training by accepting a lower wage than if the training were not part of the employment.[123] The employee, in effect, is paid in human capital. For tax purposes, employee compensation in the form of property generally is treated as if the employer paid cash wages in an amount equal to the value of the property and the employee purchased the property with the cash.[124] Similar treatment should apply to compensation in the form of human capital. Consequently, to the extent the higher wages would be deductible to the employer, the proxy in the form of training also should be deductible to the employer. The current deduction would not, then, constitute an implicit preference.[125] If cash compensation would have been capitalized or inventoried, however, the human capital expenditures should be as well. In this case, the immediate deduction would be a preference, although for employee, and not employer, human capital.

b. Effects of the Preference

There could be a number of economic effects of the implicit pref-

[119] *See supra* notes 73-79 and accompanying text.

[120] Executive Office of the President, Office of Management and Budget, Special Analysis Budget of the United States Government Fiscal Year 1988 G-44 (1987).

[121] *See supra* notes 110-13 and accompanying text.

[122] *See supra* text accompanying notes 76-79 and Table I.

[123] *See supra* text accompanying notes 58-63.

[124] *See* I.R.C. § 83 (1982 & Supp. III 1985 & West Supp. 1987); Treas. Reg. § 1.83-6(b) (1978).

[125] Under the payment-in-property approach, the employer would have income on the sale and thus would be able to offset the deduction for the amount by which the value of the human capital exceeds the employer's cost.

erence for preferred intangible capital. The ultimate effects of the preference depend on how it influences various prices (including wages). The first part of the discussion assumes no changes in prices; the second part assumes that the only prices changed are the prices of preferred intangible capital; and the third part considers other price effects.

First, if prices are not changed by the preference, there are various possible effects of the implicit preference. It encourages businesses to make preferred intangible capital expenditures (to "buy" preferred intangible capital) rather than make some alternative use of the funds available to buy preferred intangible capital. As a result, businesses probably make more preferred intangible capital expenditures than they would otherwise. This increases the sales volume of businesses that sell preferred intangible capital, such as advertising agencies, the media, research laboratories, recruiting services, training consultants, and the like. To the extent the increased intangible capital expenditures reflect increased advertising that increases consumption (over saving),[126] greater consumption results.[127] The preference also causes preferred intangible capital to pay higher after-tax returns than other uses of funds. Consequently, businesses and industries that use preferred intangible capital are more profitable after tax than other businesses and industries.

Second, assume that the preference only changes the prices of preferred intangible capital. This happens if the special tax treatment encourages taxpayers to buy more preferred intangible capital and no other factor discourages these purchases. The resulting increased demand enables sellers of preferred intangible capital to charge more than they could if there were no preference.[128] These higher prices soften the volume effects described in the preceding paragraph by discouraging preferred intangible capital expenditures, which reduces the benefits to businesses that use preferred intangible capital.[129] The higher prices, however, have other effects. Businesses that sell preferred intangible capital receive more for their products and services. This results in in-

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[126] *See* W. COMANOR & T. WILSON, *supra* note 16, at 238-39; J. SIMON, *supra* note 17, at 205.

[127] *See* J. LAMBIN, *supra* note 29, at 136-38 (noting that some, but not all, advertising might increase consumer demand). There is a nice irony in this result. A preference for advertising is an investment incentive that encourages consumption (in later periods than the investment).

[128] *See* Siegfried & Weiss, *Advertising, Profits, and Corporate Taxes Revisited,* 56 REV. ECON. & STATISTICS 195, 196 (1974).

[129] *See id.*

creased profitability for these firms, benefiting their owners.[130] These profits may not be very large, as new firms, attracted by the higher profitability, may enter the business of selling preferred intangible capital, increasing the supply and reducing the price. As a result, there may be more advertising agencies than there would be if there were no preference.

The price of preferred intangible capital determines the allocation of the benefits of the preference between the businesses buying preferred intangible capital and the businesses selling preferred intangible capital. Regardless of whether the ultimate effect of the preference is to benefit businesses that buy or sell preferred intangible capital, businesses in general benefit (assuming no other price changes) from the reduced revenues collected from businesses as compared to the revenues collected from wages (the other principal source of taxable income[131]). Assuming that the government has fixed revenue needs (and ignoring any effects of the preference on economic growth), the implicit preference requires higher tax rates than under a regime in which preferred intangible capital is treated like asset-capitalized expenditures. This results in higher *average* taxes on wages than business income, since the tax increase is shared by businesses and wage-earners, while the equal, offsetting tax reduction from the preference goes exclusively to businesses.

Third, consider other possible effects of the implicit preference. As just noted, the preference benefits business. The economic effects of a tax preference for business are unclear. If an increased tax on wages discourages work effort, which many believe,[132] the preference discourages work effort. If increased after-tax returns on business income encourage saving, investment, and capital formation, as many believe,[133] the preference has the effect of increasing saving, investment, and capital formation. Either of these effects might change wage levels (ignoring the effects on prices of consumer goods and services, discussed below). Discouraging work effort might decrease the labor supply and therefore potentially increase wages. Wages also might increase because encouraging investment, etc., might increase the demand for labor. Alternatively, the preference might encourage the substitution of intangible capital for labor, thus decreasing the demand for labor, and potentially decreasing wages.

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[130] *See id.*

[131] *See* Bradford, *supra* note 14, at 15-16 (noting that the major sources of taxable income are returns to capital and labor).

[132] *See, e.g. id.* at 20-28.

[133] *See id.*

The preference may also affect the returns earned by businesses. Investors prefer to invest in the favored businesses. Other businesses have to offer higher before-tax returns to compete with the higher after-tax returns of the preference beneficiaries. Those businesses that cannot offer competitive returns cannot raise capital and may be required to liquidate. Businesses that benefit from the preference, therefore, succeed when they might not without the preference.

These effects may change the prices of consumer goods and services. Intangible capital may benefit businesses by enabling them to charge relatively more for their goods or services (instead of increasing sales without a price effect). The preference for intangible capital, therefore, might be stimulating higher prices. On the other hand, new firms entering the businesses benefited by the preference might have driven prices down. In fact, the reduced total tax on business, by attracting saving and thereby increasing the level of business activity, might have resulted in a greater supply of goods and services and a corresponding lower price level for consumer goods and services (compared to a regime without the preference).

This analysis must be modified somewhat in the case of preferred human capital expenditures. As noted above, many of these expenditures benefit employees.[134] The employees probably finance most or all of the training that benefits them through a lower wage, so that there is little net employee benefit. To the extent, if any, training really financed by employers (i.e., not offset by lower wages) results in net benefits to employees, however, the associated intangible capital expenditures benefit employees. Under these circumstances, the implicit preference benefits those employees receiving the employer-financed training.

c. Equity and Neutrality Concerns

Each possible effect of the implicit tax preference for much intangible capital violates the equity criterion. To the extent the preference results in benefits, directly or indirectly, to only one of two similarly situated persons, horizontal equity is violated. The preference potentially provides benefits to businesses and industries that use preferred intangible capital (over other businesses and industries), to investors in businesses and industries that use preferred intangible capital (over other investors), to sellers of preferred intangible capital (over other businesses and industries), to investors in sellers of preferred intangible capital (over other investors), to those who live off income earned by

[134] *See supra* text accompanying notes 58-63.

businesses (over those who live off wages), to those who benefit from any change in the level or mix of consumer goods and services prices (over everybody else), and to those employees who receive a net benefit from employer-financed human capital expenditures (over everybody else). Each of these benefits violates the equity criterion.

Similarly, the neutrality criterion is violated. Many believe that there are good reasons to encourage saving, investment, and capital formation.[135] These people would have no objection to the preference encouraging this behavior, but others would. Many believe that incentives for R&D[136] and investment in human capital[137] are advantageous. These people would have no objection to the preference encouraging R&D and investment in human capital, but others would. Only those in advertising would argue, however, that preferences for advertising, advertisers, sellers of advertising, or investors in sellers of advertising are economically advantageous.[138] Also, the increased tax on wages is troubling. On balance, current law has severe neutrality problems, although one's judgment of the significance of the problems depends on one's views of the nature and desirability of the various indirect effects of the preference.

D. *Extra Tax on Sales*[139]

1. Applicable Law

The current rules for sales of businesses, combined with the rules for depreciation, provide markedly different treatment of self-developed and purchased intangible capital. Much self-developed intangible capital is deductible immediately.[140] Purchased intangible capital is not immediately deductible, and, moreover, is subject to very restricted depreciation rules.[141] This inconsistent treatment has the effect of imposing an extra tax on the sale of businesses with self-developed nondepreciable preferred intangible capital because the seller will always owe a tax (having no basis in the sold intangible capital) and, unlike the case with depreciable assets, the buyer will be allowed no depreciation with re-

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[135] *See, e.g.*, S. REP. No. 144, 97th Cong., 1st Sess. 11-13 (1981).

[136] *See, e.g.*, *id.*

[137] *See, e.g.*, Schultz, *supra* note 4, at 14-15.

[138] *See supra* notes 16-17 and accompanying text.

[139] The discussion in this section of the Article was motivated by *ALI*, *supra* note 4, at 120-33. *See generally* Land, *Unallocated Premium in Corporate Acquisitions Under the American Law Institute Subchapter C Proposals*, 34 TAX LAW. 341, 356-69 (1981).

[140] *See supra* notes 69-107 and accompanying text.

[141] *See infra* notes 162-65 and accompanying text.

spect to the purchased intangible capital that can cushion the economic consequences of the seller's tax by being reflected in a higher price. This extra tax is objectionable on both equity and neutrality grounds.

The sale of a business[142] is treated as a separate sale of each asset transferred with the business.[143] This requires that the total consideration paid for the business be allocated among the transferred assets in order to determine a selling price for each asset. If the aggregate price is less than the sum of the values of the individual assets, the respective selling prices of the assets are reduced proportionately.[144] When the purchase price exceeds the value of tangible assets plus identifiable intangibles, the excess consideration is allocated to goodwill.[145] The law

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[142] A transfer of a corporate business by transferring stock or in a tax-free reorganization and a transfer of a partnership business by transferring partnership interests generally have no tax consequences with regard to the assets of the business and therefore are not discussed. In certain circumstances, a transfer of corporate stock will be treated similarly to a sale of assets. I.R.C. § 338 (1982 & Supp. III 1985 & West Supp. 1987). Similarly, section 754 provides an election to treat a purchase of a partnership interest much like a sale of the partnership's assets with respect to the new partner. I.R.C. §§ 743 (1982 & Supp. III 1985), 754 (1982). The analysis in the text applies to these deemed sales.

Transfer of a business to a partnership by the partners, incorporation of a partnership or proprietorship, and liquidation of a partnership do not involve changes in ownership and generally have few tax consequences. *See* I.R.C. §§ 351 (1982 & West Supp. 1987), 721, 731 (1982). Therefore, they are not discussed. A corporate liquidation (other than a subsidiary liquidation) is treated much like a sale by the corporation to the shareholders. *See* I.R.C. §§ 331 (1982), 336 (West Supp. 1987), 337 (West Supp. 1987). The analysis in the text applies to these deemed sales.

Section 367(d) provides a special deferred toll-charge on certain otherwise tax-free transfers of intangibles to a foreign corporation. I.R.C. § 367(d) (1982 & Supp. III 1985 & West Supp. 1987). The legislative history indicates that this rule was not intended to apply to transfers of foreign goodwill and going concern value (but foreign goodwill and going concern value can be subject to the rules for a current toll-charge on incorporating loss branches in section 367(a)(3)(C)). H.R. REP. No. 432, 98th Cong., 2d Sess. 1320 (1984); EXPLANATION OF PROVISIONS, *supra* note 21, at 365; *see also* STAFF OF THE JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984 434, 435 (1984) [hereinafter 1984 BLUEBOOK]. According to the Joint Committee Staff, the rationale for the special treatment is that "[g]oodwill and going concern value are generated by earning income, not by incurring deductions. Thus, ordinarily, the transfer of these (or similar) intangibles does not result in avoidance of Federal income taxes." 1984 BLUEBOOK, *supra*, at 428. The economic evidence on the nature of goodwill and going concern value suggests that goodwill and going concern value are created by expenditures. *See supra* text accompanying notes 19-63. One wonders to what extent the Joint Committee Staff's misunderstanding informed the law.

[143] *See* Williams v. McGowan, 152 F.2d 570, 572 (2d Cir. 1945).

[144] *See* Treas. Reg. § 1.167(a)-5 (as amended by T.D. 8069, 51 Fed. Reg. 1498 (1986)).

[145] *See* I.R.C. § 1060 (West Supp. 1987); Treas. Reg. § 1.338(b)-2T (as amended by T.D. 8092, 51 Fed. Reg. 33033 (1986)). The excess is allocated to goodwill or going concern value. However, to simplify the discussion, this Article treats going concern value as a form of goodwill. While there are many views of these two intangibles, a generalization, albeit oversimplified, is helpful. *See* Note, *An Inquiry*

distinguishing amounts paid for goodwill from amounts paid for intangibles with different tax treatments, discussed below,[146] is complicated and confused.[147]

The seller is treated as having sold, and the buyer is treated as

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Into the Nature of Goodwill, 53 COLUM. L. REV. 660, 664-86, 697-707 (1953); Comment, *Depreciability of Going Concern Value,* 122 U. PA. L. REV. 484, 484-87 (1973). "Goodwill" is the extra value of a business independent from the business's other assets that is attributable to an established customer or supplier base, a good reputation, and the like. "Going concern value" is the extra value of a business that is attributable to the business being in place, running, and producing income. *See, e.g.,* Solitron Devices, Inc. v. Commissioner, 80 T.C. 1, 17-22 (1983) (Purchased firm had goodwill value where image as dependable manufacturer gave it competitive advantage, and going concern value where it would have taken purchaser 18-24 months to build business of identical size.), *aff'd without opinion,* 744 F.2d 95 (1984). *See generally* Doernberg & Hall, *supra* note 2; Grigsby & Cotter, *supra* note 2, at 555-70 (discussing case law treating going concern value as separate from goodwill); Wiener, *Going Concern Value: Goodwill by Any Other Name?,* 33 TAX LAW. 183, 184-86 (1979) (contrasting "goodwill" and "going concern value").

The Court of Claims, in Miami Valley Broadcasting Corp. v. United States, 499 F.2d 677 (Ct. Cl. 1974), created a third intangible quasi-asset: "turnkey value." "Turnkey value" is the extra price one pays a turnkey contractor for a completed and operational plant and the implicit guarantee that the parts of the whole are coordinated to function together. *Id.* at 680. It is similar to going concern value, but does not contain elements of going concern value not related to the plant—such as value attributable to trained employees, to established bookkeeping procedures, and to other activities during a start-up phase. The Court of Claims treated turnkey value as allocable among the assets constituting the plant, increasing the depreciable bases of the depreciable property. *Id.* at 679-81. A similar treatment of going concern value generally has been rejected. *See, e.g.,* United States v. Cornish, 348 F.2d 175, 184-85 (9th Cir. 1965) ("The going concern element of an operating business cannot be classified as an enhancement in market value of depreciable assets for purposes of depreciation."). *Miami Valley Broadcasting* may be inconsistent with this line of cases. *See* Wiener, *supra,* at 190-92. The best analysis is that turnkey value is merely an appraisal method for tangible property, as the value can be transferred with the assets separately from the operating business, and is not an intangible like going concern value. *Cf.* Comment, *supra,* at 497 (Some elements of going concern value should be depreciable, because they may have reasonably estimable useful lives.).

Prior to enactment of section 1060 in the 1986 Act, there was some confusion in the treatment of any excess. When one asset is purchased, its purchase price is its purchase price, even if that price exceeds a price that otherwise might have been available if the buyer had not been in a hurry, had been in a different location, etc. The same should be true if a collection of assets is purchased. *See* Treas. Reg. § 1.167(a)-5 (as amended by T.D. 8069, 51 Fed. Reg. 1498 (1986)). Consequently, taxpayers were arguing that in business purchases with huge excesses that any goodwill or going concern value had little value (using appraisals), so that most of the excess could be allocated to depreciable assets or inventory. The 1986 Act was intended to eliminate this argument. *See* S. REP. NO. 313, 99th Cong., 2d Sess. 251-55 (1986). The issue is a hard one. If the buyer paid "too much," the tax law should reflect this. Conversely, any excess is the best market evidence of the value of goodwill and going concern value. Given that the "too much" situation seems unlikely, and that the section 1060 result provides admirable simplicity, the 1986 provision seems sound.

[146] *See infra* text accompanying notes 162-65.

[147] *See* Dubin, *Allocation of Costs to, and Amortization of, Intangibles in Business Acquisitions,* 57 TAXES 930, 945 (1979).

having purchased, each asset for a price equal to the amount of consideration allocated to the asset.[148] Each asset sale results in gain or loss to the seller.[149] The amount of gain (or loss) is the difference between the consideration received for the asset and the asset's "adjusted basis" to the seller at the time of sale. The seller's original purchase price for the asset was the seller's "cost basis" in the asset.[150] This cost basis was increased by other capitalized expenditures and reduced by the seller's depreciation to determine the seller's "adjusted basis."[151]

Taxable gain on the sale of an asset generally is "long-term capital gain."[152] Long-term capital gain currently receives a tax preference, a maximum rate of 34% for corporations (compared to a maximum rate on ordinary income of 40% plus a surtax) and 28% for individuals (compared to a maximum rate of 38.5%).[153] Basically, the preference will expire if the ordinary income rates come down as scheduled in 1988 (to 34% plus a surtax for corporations, 28% plus a surtax for individuals).[154] It seems possible, however, that due to the federal deficit, the rates will not be reduced as scheduled. If this happens, a preference for capital gain might be retained. Consequently, this Article takes the preference into account.

In the case of personal property that has been subject to depreciation, any gain generally is ordinary income and not capital gain.[155] This ordinary income is referred to as "depreciation recapture," as it recaptures the ordinary depreciation deductions claimed to the extent they exceed the asset's decline in value.[156] Gain attributable to the amount by which the sale price exceeds the original cost basis is not

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[148] *See* Williams v. McGowan, 152 F.2d 570, 572 (2d Cir. 1945).

[149] I.R.C. §§ 61(a)(3) (1982), 1001(a) (1982).

[150] I.R.C. § 1012 (1982).

[151] I.R.C. § 1016(a)(1), (2) (1982 & Supp. III 1985 & West Supp. 1987); Treas. Reg. § 1.1016-2(a) (1957).

[152] Gain or loss on most non-business assets (held for over six months) generally is "long-term capital" gain or loss. I.R.C. §§ 1221 (1982), 1222 (1982 & Supp. III 1985). Gain on most non-inventory business assets (held for over six months) is "section 1231 gain" or "section 1231 loss." I.R.C. §§ 1231(a)(3), (b) (1982 & Supp. III 1985). The six-month period becomes one year for property acquired after January 1, 1988. Tax Reform Act of 1984, Pub. L. No. 98-369, § 1001(e), 98 Stat. 1012 (1984). Subject to complicated netting and carry forward rules (and the recapture rules discussed *infra* text accompanying notes 155-57), section 1231 gain generally is treated as long-term capital gain and section 1231 loss generally is treated as an ordinary loss. I.R.C. §§ 1231(a), (c) (1982 & Supp. III 1985). For simplicity, this Article generally refers to section 1231 gain as capital gain and to section 1231 loss as ordinary loss.

[153] *See* I.R.C. §§ 1, 11 (1982 & Supp. III 1985 & West Supp. 1987), 15 (Supp. III 1985 & West Supp. 1987), 1201 (1982 & Supp. III 1985 & West Supp. 1987). The preference applies after the application of various netting rules.

[154] *See id.*

[155] *See* I.R.C. § 1245 (1982 & West Supp. 1987).

[156] *See* M. CHIRELSTEIN, *supra* note 78, at 321.

subject to depreciation recapture, and generally qualifies as capital gain.[157]

There is some uncertainty in the taxation of sales of goodwill. In general, gain on goodwill is capital gain.[158] The "tax benefit rule"[159] or the "*Corn Products* doctrine"[160] may convert gain on goodwill to ordinary income under certain circumstances.[161] This gain is likely to be substantial, since, unless the seller itself previously purchased the business, the seller probably has a zero adjusted basis in goodwill, having immediately deducted the associated expenditures under the rules described above.

Expenditures on purchased intangible capital (for example, goodwill acquired when a going business is purchased) are not allowed as an immediate deduction.[162] The regulations provide that an intangible asset is depreciable only if it is useful in the business for a reasonably estimable limited period.[163] In particular, the regulations provide that goodwill cannot be depreciated.[164] Because of the limited useful life requirement, buyers of goodwill and similar intangibles are not allowed

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[157] *See* I.R.C. §§ 1231 (1982 & Supp. III 1985), 1245 (West Supp. 1987).

[158] *See, e.g.,* Watson v. Commissioner, 35 T.C. 203, 209 (1960) (sale of goodwill generally produces capital gain). There is no direct authority on a sale of going concern value, but the reasoning underlying the goodwill authority should lead to this result.

[159] The tax benefit rule, inter alia, converts capital gain on the sale of an asset to ordinary income to the extent that the gain represents a recovery of non-depreciation deductions previously taken with respect to the asset. *See* Merchants Nat'l Bank v. Commissioner, 199 F.2d 657, 659 (5th Cir. 1952); Rowen, *Research and Development Partnerships: Section 174 and Capital Gain,* 63 TAXES 523, 536-37 (1985). The I.R.S recently ruled that a sale of technology does not result in an ordinary income recapture of research and experimentation deductions. Rev. Rul. 85-186, 1985-2 C.B. 84. The rationale of the ruling is that tax benefit recapture would undermine the tax incentive purpose of the special provision allowing an immediate deduction of research or experimental expenditures. Implicitly, therefore, the tax benefit rule could apply to sales of intangible capital created by regular deductions. In dictum, however, the ruling notes that regular deductions generally cannot create an asset that can be disposed of in a transaction subject to tax benefit recapture. The ruling, therefore, only confuses matters for intangible capital not created by research or experimental deductions. *See* Krasner, *Tax Benefit Rule and Related Doctrines as Applied to the Recapture of Research and Other Intangible Development Costs,* 60 ST. JOHN'S L. REV. 26, 28 (1985).

[160] The "doctrine" is named after Corn Products Refining Co. v. Commissioner, 350 U.S. 46 (1955), *reh. den.* 350 U.S. 943 (1956). It provides that gain on assets integrally related to the business is ordinary income. *See* Heyde, *Transfers of Technology: The Appropriateness of Capital Gain Treatment,* 64 TAXES 3, 10-11 (1986).

[161] An interesting question is how to determine how long intangible capital has been held for purposes of the special treatment of gain on assets held for more than a year (or six months). Goodwill, for example, arguably is reacquired each day. *See* Harding, *supra* note 4, at 320-21; Olson, *supra* note 4, at 564-66.

[162] Treas. Reg. § 1.263(a)-2(h) (1958).

[163] Treas. Reg. § 1.167(a)-3 (as amended by T.D. 6452, Feb. 3, 1960).

[164] *Id.* Gregorcich argues that it might be possible to depreciate goodwill if one is able to develop remarkable proof of a limited life. Gregorcich, *supra* note 2, at 271-85.

to depreciate the assets, since these assets are viewed as not having limited useful lives.[165]

2. The Problem

A buyer of a depreciable asset claims depreciation based on the purchase price. Consequently, when the purchase price exceeds the seller's adjusted basis in the asset at the time of sale, the sale results in increased future depreciation deductions with respect to the asset. These new tax benefits can be viewed as reducing or eliminating the total tax resulting from the sale. If the buyer and seller are in the same tax bracket, the gross income generated by the asset will be subject to roughly the same tax to the buyer as it would have to the seller. Consequently, to the extent the seller's tax on the sale is offset, in present value terms, by increased buyer deductions, the sale has less effect on the total tax on the income generated by the asset. If the capital gain preference expires, or, if it continues (to the extent the sale price is less than the original cost of depreciable personalty), there probably still will be a small net tax increase. Under these circumstances, it is likely that the seller's ordinary income tax or recapture on the gain will be a greater burden in present value terms than the buyer's new deductions, in an amount equal to the gain, are a benefit. This would occur because the gain tax is paid currently and the deductions, while equal in amount, are in the future and therefore smaller in present value.[166] In a world with a meaningful capital gain preference, for depreciable real property, and, to the extent the sale price exceeds the original cost basis, with respect to personal property, however, any gain is taxed only at capital gain rates, which probably is less of a burden than the buyer's associated deductions are a benefit. In fact, under these circum-

[165] *See, e.g.,* X-Pando Corp. v. Commissioner, 7 T.C. 48, 53-54 (1946). If the business terminates, any amount allocated to goodwill or going concern value is deductible as an ordinary loss. *See* Edison Int'l, Inc. v. United States, 10 Cl. Ct. 287, 288 (1986); Schenk, *supra* note 6, at 521-23.

[166] R. GILSON, M. SCHOLES & M. WOLFSON, TAXATION AND THE DYNAMICS OF CORPORATE CONTROL: THE UNCERTAIN CASE FOR TAX MOTIVATED ACQUISITIONS 10-20 (Stanford Law and Economics Program Working Paper No. 24, 1986). Gilson, et al. make an interesting point. Even with full taxation of capital gain, taxation can be deferred by installment reporting under section 453. *Id.* at 21-26. Section 453 generally permits the deferral of gain when a seller of property takes back a note until principal payments are made on the note. I.R.C. § 453 (1982 & Supp. III 1985 & West Supp. 1987). Consequently, the no- or zero-tax result may be possible even in a no-capital-gain preference world. Section 453 does not eliminate the extra tax on sales of intangible capital, however, since only an unusual installment note will be of sufficiently long term to defer the seller's gain until the time (liquidation) of the buyer's associated deduction.

stances, a taxable sale can result, in present value terms, in no net tax increase and perhaps a tax reduction on the income generated by the asset.[167] While it seems unlikely that this happens sufficiently fre-

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[167] This can be seen in a simple example. Assume that the market interest rate is 10%. The corporate tax rate is 40% and the capital gain rate 34%. A piece of personal property is subject to three-year straight-line (pro rata) depreciation with no salvage value. Current recapture law, but not the half-year convention, applies. The buyer steps into the seller's depreciation period, which, as discussed below, is not current law. At the beginning of year 1, *X*, a corporation, acquired the property for $100, claiming $33.3 of depreciation in year 1. At the beginning of year 2, the property is sold to *Y*, a corporation, for $150. *X* pays a total tax on the sale of $30.3 ([40% of $33.3] + [34% of $50]). As a result of the sale, *X* lost deductions as follows:

Table II

	Deduction	Tax Benefit	Present Value of Benefit
Year 2	33.3	13.3	13.3
Year 3	33.3	13.3	12.5
			25.8

The after-tax present value of the total tax cost of the sale to *X*, ignoring the tax that would have resulted from the income generated by the asset, which is the same to *X* and *Y*, is $56.1 ($30.3 + $25.8). The total tax benefit to Y, again ignoring the tax on the income generated by the asset, is:

Table III

	Deduction	Tax Benefit	Present Value of Benefit
Year 2	75	30	30
Year 3	75	30	28.3
			58.3

The tax benefits to *Y* exceed the tax cost to *X*, even with full recapture.

Two aspects of current law not reflected in this example change the analysis somewhat. First, under current law, a buyer must start a new depreciation period. *See* I.R.C. § 168(a) (West Supp. 1987). This means that the buyer's depreciation deductions are spread out over a longer period than the seller's would have been, increasing the extra tax. Second, current law provides accelerated depreciation. *See* I.R.C. § 168 (West Supp. 1987). This means that, since a buyer's depreciation starts in the fast early years of an accelerated schedule while the seller's would have been in slower later years, the buyer gets deductions more quickly, reducing the extra tax. These two effects work against and can offset each other.

This can be seen by altering the example above to reflect the current law's 200% of straight-line declining balance depreciation (with crossover to straight-line when more favorable), half-year convention, and restart of the depreciation period by the buyer. In this case, *X* would have claimed $33.4 depreciation in year 1 and $22.2 in year 2. The tax on the sale would be $39.2 ([40% of $55.6] + [34% of $50]). The lost deductions are:

quently that one can say there is no net tax increase as a result of these sales, it is clear that buyer depreciation significantly reduces the net tax resulting from sales. It also is clear that the shorter the depreciation period of the asset, the less likely that there will be a tax increase, as the shorter the depreciation period, the greater the present value of the new depreciation deductions created by the sale.

There are convincing reasons for viewing the buyer's new deductions as compensation for the seller's tax. The value of the asset to buyers and sellers is the present value of the after-tax cash flow.[168] If buyers get more favorable depreciation than sellers, the asset will generate more after-tax cash flow to buyers than sellers, if they are in roughly equal tax brackets. Therefore, the asset will be worth more to buyers than sellers. Buyers would be willing to pay a price at which all sellers would sell, if it were not for the gain tax, a new tax imposed with respect to the asset that would not be imposed if the asset were not sold. Because of the gain tax, the price must be set sufficiently high so that the after-tax proceeds of a sale to a seller equals the present value of the after-tax future cash flow that the asset would have generated. Buyers are willing to pay a "high" price (compared to a world with no

Table IV

	Deduction	Tax Benefit	Present Value of Benefit
Year 2	22.2	8.9	8.9
Year 3	14.8	5.9	5.6
Year 4	7.4	3	2.7
			17.2

The tax cost to *X* is $56.4 ($39.2 + $17.2). *Y*'s benefits are:

Table V

	Deduction	Tax Benefit	Present Value of Benefit
Year 2	50.1	20	20
Year 3	66.6	26.6	25.1
Year 4	22.2	8.9	7.9
Year 5	11.1	4.4	3.7
			56.7

The two effects roughly offset each other.

[168] *See supra* text accompanying notes 23-24.

taxes) because of their new tax benefits. The "high" price compensates sellers for the gain tax, but reduces the benefits to buyers. In other words, sellers' taxes can be shifted to buyers through a higher price. If there is no net tax increase, in present value terms, on the income generated by the asset, and the price adjusts perfectly, there is no effective tax on the sale. The higher price offsets the seller's gain tax and eliminates the buyer's benefits. A net tax increase, however, cannot be compensated for through a price adjustment. One must look at both sides of the sale to see if there is a net tax increase.[169]

The sale of a depreciable asset probably results in a relatively small increase in the net tax on the cash flow generated by the asset looking at both the seller and the buyer.[170] In contrast, the sale of self-developed nondepreciable preferred intangible capital probably results in a significant net tax increase. Most or all expenditures associated with the intangible were deducted, so that the seller has little or no basis in the intangible capital. Any amount allocated to self-developed preferred intangible capital, therefore, results in a taxable gain. The gain could be characterized as ordinary income, in effect recapturing the "accelerated depreciation" in the form of immediate deductions. The buyer of a nondepreciable intangible gets no depreciation. Consequently, unlike the case with depreciable property, the buyer's tax benefits provide little relief from the seller's tax. Under these circumstances, the buyer of a nondepreciable intangible is not willing to pay a "high" price to compensate for the seller's tax, as in the case of depreciable property. This results, in effect, in an "extra" tax on sales of businesses with self-developed nondepreciable preferred intangible capital that is present only to a much smaller extent with respect to depreciable property.

This extra tax on sales of businesses with self-developed nondepreciable preferred intangible capital is troublesome. It treats similar businesses differently depending upon the amount of such intangible capital owned, violating the equity criterion. The extra tax also modifies behavior by discouraging sales of businesses with relatively more self-developed nondepreciable preferred intangible capital, as compared to sales of businesses with relatively less. This reduces the general tax

[169] *See* R. GILSON, M. SCHOLES & M. WOLFSON, *supra* note 166, at 10-15.

[170] This is true only on average. In a given sale, there is likely to be some positive or negative net tax. Buyers and sellers can be in different brackets. The price that makes a seller whole depends upon the difference between the value of the asset and its adjusted basis to the seller, which varies with how long the seller has held the asset and with the market. Also, the ability of the market to compensate may depend upon the depreciation period of the asset. Any of these factors changes the tax on a particular transaction.

benefits for preferred intangible capital, but at the price of changing behavior with regard to business sales. There is no evidence that discouraging sales of businesses with self-developed nondepreciable preferred intangible capital is economically advantageous.

It is likely that the extra tax applies rather frequently.[171] There are a wide variety of preferred intangible capital expenditures, which, in the aggregate, are huge in amount.[172] Large intangible capital premiums have been present in recent acquisitions. For example, when Exxon acquired Reliance Electric Company in 1979 for $1.236 billion, the purchase price exceeded the value of identifiable assets by $327 million.[173] There is no economic analysis of the magnitude of the effect of the extra tax, however. Nevertheless, lawyers planning business purchases and sales have long recognized the central role of trying to avoid the extra tax by allocating the purchase price away from goodwill and to depreciable assets.[174] It seems reasonable to conclude that the extra tax also affects decisions about what businesses are bought and sold and the prices paid in such transactions.

E. *Implicit Preference for Ongoing Businesses*

1. Applicable Law

The third problem with current law is an implicit preference for ongoing businesses. There are special limitations on the deductions of start-up businesses. Many expenditures disallowed as a deduction by the start-up rules are preferred intangible capital expenditures present

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[171] Section 736 provides elective special treatment for a partner who retires from a partnership with goodwill. This treatment has the effect of avoiding the extra tax that would result if the retirement were treated as a sale of the partnership interest. *See* W. McKee, W. Nelson & R. Whitmire, Federal Taxation of Partnerships and Partners ¶ 15.02[2][a] (1977). With a properly drafted partnership agreement, payments for goodwill are not treated as a sale, but as if the retiring partner merely received a profit share, just as if the partner had continued with the partnership. *See* I.R.C. § 736 (1982).

[172] *See supra* text accompanying notes 109-113.

[173] Exxon, 1979 Annual Report 29 (1980).

[174] *See, e.g.*, Dubin, *supra* note 147, at 945 ("Imagination, and diligence in assembling documentation, can yield handsome rewards to the thoughtful and energetic planner."); Howell, *Amortization of Acquired Intangibles: Evaluation of Current Case Law*, 32 J. Tax'n 344, 349 (1970) ("[A]wareness of the factors which determine whether a taxpayer will be able to depreciate newly acquired intangible assets can be a valuable planning aid."); Rettig, *Tax Recovery of the Cost of Intangible Assets: Careful Analysis and Planning Necessary*, 18 J. Tax'n 154, 162 (1963) (Tax planner must use "imagination and thoughtfulness in analysis" in order to support characterization of intangible assets as depreciable goods.); *see* Note, *supra* note 145, at 728-31 (noting purchasers' attempts to allocate as little of purchase price as possible to cost of goodwill).

in ongoing businesses. Consequently, the start-up rules produce an implicit preference for ongoing businesses.

Two special rules apply to a business in the "start-up" phase, the period prior to ordinary business operations. First, most courts that have addressed the issue have concluded that expenses are deductible only at those times that the business is "carrying on."[175] A business is not "carrying on" in the start-up phase. Second, section 195 explicitly disallows the deduction of "start-up expenditures."[176] The scope and application of the "carrying on" requirement[177] and section 195[178] are

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[175] *See, e.g.,* Madison Gas & Elec. Co. v. Commissioner, 633 F.2d 512, 517 (7th Cir. 1980) (pre-operational start-up costs are nondeductible); Richmond Television Corp. v. United States, 345 F.2d 901, 907 (4th Cir.) (start-up costs are non-current capital expenditures incurred not while "engaged in carrying on any trade or business" and therefore not deductible), *vacated and remanded on other grounds per curiam,* 382 U.S. 68 (1965). *See generally* Lee, *supra* note 2, at 41-51. The rationale of the cases is that section 162 allows deductions only for amounts incurred in "carrying on" a trade or business and that "carrying on" imposes a temporal limitation. The Court of Claims and the Claims Court have held that "carrying on" does *not* impose a temporal limitation, but is merely part of the general limitation of deductions to nonpersonal expenditures. *See* Brotherman v. United States, 6 Cl. Ct. 407, 410 (1984); Blitzer v. United States, 684 F.2d 874, 880 (Ct. Cl. 1982). Individuals have successfully deducted expenses incurred prior to carrying on a trade or business by treating them as expenses of activities engaged in for the production of income that are deductible under section 212, which contains no "carrying on" requirement. I.R.C. § 212 (1982); *see* Lewis v. Commissioner, 51 T.C.M. (CCH) 868, 872 (1986) (result not affected by 1984 change to § 195); Hoopengarner v. Commissioner, 80 T.C. 538, 541 (1983), *aff'd mem.,* 745 F.2d 66 (9th Cir. 1984). *But see* Johnsen v. Commissioner, 794 F.2d 1157, 1162-63 (6th Cir. 1986) (declining to follow *Hoopengarner* and limiting § 212 to "nonbusiness income"); Aboussie v. United States, 779 F.2d 424, 428 n.6 (8th Cir. 1985) (same). Corporations, however, may not take such a deduction.

Commissioner v. Groetzinger, 87-1 U.S. Tax Cas. (CCH) ¶ 9191 (U.S. 1987), rejected the traditional test of a trade or business, selling goods or services, and held that a full-time gambler is engaged in a trade or business. There has been some speculation that *Groetzinger* might have the effect of allowing the deduction of some start-up costs. *See* Uhlfelder, *High Court's Groetzinger Decision Could Affect Deductibility of Some Construction Expenses,* 34 TAX NOTES 856, 856 (1987). *See generally* August & Levine, *Goods and Services Test for Trade or Business Rejected by Supreme Court,* 66 J. TAX'N 298 (1987). This seems wrong, since the start-up cases interpret "carrying on," not "trade or business," which was the issue in *Groetzinger.* The Supreme Court in Snow v. Commissioner, 416 U.S. 500, 503 (1974), discussed *infra* at text accompanying note 337, allowed a start-up business to deduct research or experimental expenditures under section 174 because section 174 does not contain "carrying on" language, although section 174 does require the existence of a trade or business. By implication, a different result would have been reached if section 174 contained "carrying on" language.

[176] I.R.C. § 195 (1982 & Supp. III 1985). Section 195 was originally adopted in 1980 to provide 60-month or longer depreciation of "carrying on" amounts. *See* S. REP. No. 1036, 96th Cong., 2d Sess. 11 (1980). It was amended in 1984 to provide an affirmative disallowance in response to the cases limiting "carrying on" discussed *supra* at note 175. *See* EXPLANATION OF PROVISIONS, *supra* note 21, at 283. *See generally* Lee, *supra* note 2, at 71-89.

[177] It is not clear what is a new business subject to "carrying on." A bank previously engaged solely in banking opening a gas station probably would result in disal-

intricate and uncertain. It is clear, however, that the two rules, either

lowance of start-up costs for the gas station. In contrast, a bank opening new branches has been held to constitute a new business for "carrying on" purposes, relying on section 195 legislative history. *See* NCNB Corp. v. United States, 684 F.2d 285, 290-92 (4th Cir. 1982).

The cases also do not indicate when the start-up phase terminates. Authority in analogous areas may be helpful. Sections 248(a) and 709(b) provide that corporations and partnerships, respectively, may elect to amortize organizational expenses commencing when the entity "begins business." I.R.C. §§ 248, 709 (1982). The regulations generally provide that business begins when the entity's activities are sufficient to establish the nature of the business. *See, e.g.*, Treas. Reg. §§ 1.248-1(a)(3) (1956), 1.709-2(c) (1983). Acquiring operating assets ready to be used in the business generally satisfies this standard. *See id.* There is some indication, however, that this is not the standard for "carrying on" purposes. *See* Fowler, *The Continuing Saga of Start-up Costs and Their Identification*, 17 TAX ADVISER 244, 250 (1986); Ludtke, Vitek & Witt, *Tax Aspects of the Formation and Initial Operation of a Real Estate Limited Partnership*, 39 TAX LAW. 195, 196-99 (1986).

The accounting rules for determining what expenditures relate to the start-up phase also are unclear. The cases do not discuss whether the disallowance applies to amounts paid in the start-up phase, to amounts incurred in this phase, or to some other amounts, or whether the result depends on the taxpayer's accounting method for the relevant expenditures.

[178] There are three basic issues: (i) the type of expenditures subject to section 195; (ii) the type of businesses subject to section 195; and (iii) when these expenditures of these businesses are subject to the deduction limitation.

First, one must determine what type of expenditures are potentially subject to section 195. The section basically applies to expenditures made to investigate, create, or operate a separate "active trade or business" prior to the time the business is acquired or becomes active if the amounts would be deductible to an existing business. I.R.C. § 195(c)(1) (1982 & Supp. III 1985). This definition was intended to include all conceivable start-up costs. *See* EXPLANATION OF PROVISIONS, *supra* note 21, at 283. It is not clear that it achieves its purpose. *See* Bradley, *Deductibility of a Partnership's Investigation and Start-up Expenses*, 2 J. PARTNERSHIP TAX'N 233, 251-54 (1985); Lee, *supra* note 2, at 102-08.

Second, one must determine what type of businesses are subject to section 195. The law is unclear as to what constitutes a separate "active" trade or business. In general, an active trade or business requires more activities than a mere trade or business. *See* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 13.04 (4th ed. 1979) ("Active" business requires more activity than mere trade or business for purposes of section 355.); Lee, *supra* note 2, at 102-18. The 1980 legislative history suggests that, for purposes of section 195, an active trade or business is any trade or business. *See* S. REP. NO. 1036, 96th Cong., 2d Sess. 12 (1980). The 1984 Senate Finance Committee Report contains the confused observation that "[a]ctive trade or business means that the taxpayer is actively conducting a trade or business. This definition of active trade or business may include a trade or business that is in many respects passive." *See* EXPLANATION OF PROVISIONS, *supra* note 21, at 283.

Third, one must determine to what periods section 195 applies. Section 195 could apply to different periods than "carrying on." *See generally* Fowler, *supra* note 177, at 248; Lee, *supra* note 2, at 91-101; Ludtke, Vitek & Witt, *supra* note 177, at 196-99. The history of the section 195 depreciation rule, *see supra* note 176, further confuses matters. The statute suggests that the start-up phase should end when this depreciation begins, so that depreciation authority is relevant to start-up period issues. I.R.C. § 195(b)(1) (1982 & Supp. III 1985). Under pre-1984 law, depreciation commenced when the "business began." I.R.C. § 195(a) (1982), *amended by* I.R.C. § 195(a) (Supp. III 1985). The 1980 legislative history indicated that the sections 248 and 709 standards of when business begins, *supra* note 177, applied for this purpose. S. REP.

or both of which may apply to a start-up business,[179] disallow the deduction of many intangible capital expenditures that would be deductible under the general asset-capitalized rules. For example, the two rules may disallow the deduction of the costs of financial institution marketing surveys[180] to a new financial institution, or to an existing company entering a new financial business, but not to an ongoing business.[181]

Expenditures disallowed as a deduction because of the "carrying on" requirement or section 195 may be deductible in later years. Amounts subject to section 195 may be depreciated over periods longer than 60 months, commencing at the end of the start-up period.[182] Items subject to the "carrying on" requirement, but not subject to section 195, are not depreciable, and it is unclear whether they are deductible when the business is disposed of or abandoned.[183]

No. 1036, 96th Cong., 2d Sess. 14 (1980). Consequently, this legislative history suggests that sections 248 and 709 standards, and not the section 162 standards, if different, apply for purposes of section 195. The 1984 legislation, however, provides that amortization does not begin until the commencement of an *active* trade or business, perhaps changing the start-up period result. I.R.C. § 195(b)(1) (1982 & Supp. III 1985).

[179] This seems clear from the independence of the statutory provisions. The only indication that this might not be the result is language in the Finance Committee Report on the 1984 Act: "The bill provides that a taxpayer will be required to treat start-up expenditures for which no deduction is currently allowed as deferred expenses." EXPLANATION OF PROVISIONS, *supra* note 21, at 283. "[N]o deduction is currently allowed" refers to the "carrying on" requirement. This quotation therefore suggests that section was intended to make the "carrying on" requirement superfluous. Given the imprecision of the quotation and the absence of any other similar indication, however, it seems that the two start-up rules are independent. The issue might be moot, as section 195 might be so broad that "carrying on" has no separate role. Nevertheless, as discussed *supra* note 178, section 195 may miss some "carrying on" situations.

[180] *See supra* notes 83-87 and accompanying text; Lee, *supra* note 2, at 89-91.

[181] At least this rule has been adopted in the Fourth Circuit. *See* NCNB Corp. v. United States, 684 F.2d at 285; *supra* note 177.

[182] I.R.C. § 195(b)(1) (1982 & Supp. III 1985). If the business is disposed of or abandoned before the end of the depreciation period, any nondeducted balance might be deductible at that time as a loss. Section 195 merely says that these amounts are subject to section 165. I.R.C. § 195(b)(2) (1982 & Supp. III 1985). However, it is not clear how section 165 applies. *See infra* note 183.

[183] As to nondepreciable intangibles, a loss deduction is provided by section 165. I.R.C. § 165 (1982 & Supp. III 1985 & West Supp. 1987); Treas. Reg. § 1.165-2 (1960); *see, e.g.*, Rudd v. Commissioner, 79 T.C. 225, 241 (1982) (Name of well-established public accounting firm was an intangible asset for which a loss deduction was available under section 165 upon dissolution of firm and abandonment of name.). Under section 165, a corporation's losses generally are deductible, while an individual's losses are deductible only if they are incurred in a trade or business, in a "transaction entered into for profit," or if they are casualty or theft losses. I.R.C. §§ 165(a), (c) (1982 & Supp. III 1985 & West Supp. 1987). Some amounts that violate "carrying on" can be viewed as not incurred in a trade or business or a transaction entered into for profit and therefore may not be deductible by an individual as a loss upon the abandonment of the enterprise. *See* Rev. Rul. 77-254, 1977-2 C.B. 63 (An individual's

2. The Problem

The principal object of the start-up disallowances is preferred intangible capital. Consider the nature of the expenditures disallowed as a deduction by the start-up rules. Assuming that the start-up phase does not end until income is being earned, no expenditures during the start-up phase can relate to current taxable income, since there is no taxable income in the start-up phase. Most asset-capitalized expenditures of a start-up business would not be deductible to a going concern. The disallowed deductions therefore must arise primarily from intangible capital expenditures that would be deductible to an ongoing business.

Start-up businesses are not the only businesses that make preferred intangible capital expenditures.[184] Consequently, the start-up rules' principal effect is to provide less favorable treatment of preferred intangible capital of start-up businesses than of other businesses. This effects an implicit preference for ongoing businesses.[185]

The implicit preference for ongoing businesses is objectionable on equity grounds. For example, it is unfair that a large financial institution can deduct the costs of developing a new branch (at least in the Fourth Circuit) while a new financial institution starting up in the same location cannot.[186] The implicit preference also violates the neutrality criterion. New businesses bear an extra tax burden in comparison with ongoing concerns. Because of the higher after-tax returns available to investors in ongoing businesses, investors are more likely to invest in ongoing businesses. There is no apparent economic advantage

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expenses incurred in the course of a preliminary investigation of a business are not deductible.). *See generally* Wilberding, *supra* note 2 (An individual is generally unsuccessful in deducting expenses incurred in the investigation of a prospective business.). Although there is little authority on the issue, the limitations on the deductibility of an individual's losses incurred in activities that do not satisfy "carrying on" should not apply to corporations. *Cf.* Rev. Rul. 73-580, 1973-2 C.B. 86 (A corporation's acquisitions department's expenses must be treated as costs of the acquisitions, with a loss allowable when an acquisition is abandoned.). *See generally* Wabich, *supra* note 87, at 378-80 ("Expenditures incurred in unsuccessful acquisition attempts . . . are added to the assets or stock *actually acquired*; they do *not* create independent, stand-alone assets. If an attempt is unsuccessful, the expenditures retain their ordinary (noncapital) status and are fully deductible as ordinary and necessary business expenses.").

[184] *See supra* text accompanying notes 28-65.

[185] Intriguingly, the amortization of start-up costs generally is treated by the federal government as a tax expenditure for budgetary purposes, implying that the normal, correct treatment is no deduction. *See, e.g.,* EXECUTIVE OFFICE OF THE PRESIDENT, OFFICE OF MANAGEMENT AND BUDGET, *supra* note 120, at G-38 (The estimated tax expenditure for start-up costs was between $300 and 350 million for each of the years 1985-1987.).

[186] *See supra* text accompanying notes 83-87.

to preferring established businesses. Making it more likely that established concerns undertake what a new business might do better violates the neutrality criterion.

Intangible capital taxation is not the only aspect of current law that benefits ongoing businesses over start-up enterprises.[187] Current law provides that depreciation does not commence until property is placed in service in a business.[188] This rule prevents some start-up businesses from claiming depreciation deductions that would be allowed to an ongoing business under similar circumstances. Likewise, the net operating loss ("NOL") rules[189] also operate to benefit ongoing concerns. Under these rules, when deductions exceed gross income in a year, no tax benefit with regard to the current tax year results from the excess. The excess is a NOL. Taxpayers are allowed to treat the NOL as deductions in the three previous years to the extent that income exceeded deductions in those years.[190] Otherwise, the NOL carries forward as deductions for future years.[191] The deductions in later years are not as valuable in present value terms as current deductions. Start-up businesses frequently generate NOLs and cannot use the carry back. Consequently, the NOL rules serve to give start-up businesses deferred, less valuable deductions than are allowed to profitable ongoing businesses. Notwithstanding these other provisions that benefit ongoing

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[187] Prior to the 1986 Act, special rapid depreciation was provided for trademark and trade name expenditures. *See* Tax Reform Act of 1986, Pub. L. No. 99-514, § 241, 1986 U.S. CODE CONG. & ADMIN. NEWS (100 Stat.) 2181 (repealing former section 177 relating to the amortization of trademark and trade name expenditures). The Finance Committee Report tells an interesting story of congressional concern for small business:

> Congress enacted the special amortization provision for trademark and trade name expenditures in 1956 in part because of a perception that certain large companies whose in-house legal staff handled trademark and trade name matters were able in some cases to deduct compensation with respect to these matters, because of difficulties of identification, while smaller companies that retained outside counsel were required to capitalize such expenses. The committee does not believe that the possibility that some taxpayers may fail accurately to compute nondeductible expenses is a justification for permitting rapid amortization.

S. REP. No. 313, 99th Cong., 2d Sess. 256 (1986) (footnote omitted).

[188] *See* I.R.C. §§ 168(a), (d) (West Supp. 1987); Treas. Reg. § 1.167(a)-10(b) (as amended in 1982). For example, in Piggly Wiggly Southern, Inc. v. Commissioner, 84 T.C. 739, 745-48 (1985), equipment in remodeled stores was placed in service in the year it was installed, but similar equipment in new and relocated stores was not placed in service until the new and relocated stores opened.

[189] *See* I.R.C. § 172 (1982 & Supp. III 1985 & West Supp. 1987).

[190] *See* I.R.C. §§ 172(a), 172(b)(1)(A) (1982 & Supp III 1985 & West Supp. 1987).

[191] *See* I.R.C. §§ 172(a), 172(b)(1)(B) (1982 & Supp. III 1985 & West Supp. 1987).

businesses, however, the problems resulting from the taxation of intangible capital are real and merit attention, even though solving the intangible capital problems will not eliminate the bias in favor of established concerns.

II. Reasons for Current Law

A. *The Economics and Taxation of Expenditures*

Theoretically, there are a variety of ways to structure a tax on business net income. Current law basically taxes income related to gain or loss on assets on a transactional basis: except for depreciation, gain or loss is determined when the asset is disposed of, so that one transaction, the ownership of the asset, is accounted for in its entirety independently from other transactions. Most other income is accounted for on a nontransactional basis: gross income and deductions are accounted for separately with no attempt to determine profit or loss on a given transaction. Depreciation is allowed for expected declines in business asset value. This basic regime appears to be the most workable way to structure a tax on business net income, as it provides the flexibility required to deal with three types of uncertainty: (i) uncertainties in valuing assets; (ii) uncertainties in accounting for certain types of transactions; and (iii) uncertainties in accounting for tax-significant future expectations.

Expenditures generally are divided into three types: (1) expenditures to purchase, produce, develop, construct, or improve something viewed as an asset that can be transferred separately from the associated business ("asset-related expenditures"); (2) expenditures to increase net operating income in the current year ("current expenses"); and (3) expenditures to increase net operating income in future years that are not associated with something viewed as a transferable asset ("prospective expenditures").[192] The three types of business expenditures are more alike than they first appear. All three types of expenditures are made to generate a receipt.[193] Rational businessmen expect to get their money's worth from any expenditure. For example, in the case of expenditures to purchase an asset, the associated receipt is the purchased asset, which, in turn, will generate future cash receipts. Similarly, expenditures to improve an asset result in a receipt in the form

[192] "Prospective expenditures" is a term coined solely for purposes of this Article.
[193] *See* Basic Concepts and Accounting Principles Underlying Financial Statements of Business Enterprises, Statement of the Accounting Principles Board No. 4, ¶ 184 (Am. Inst. of Certified Pub. Accountants 1970). *See infra* note 194.

of a more valuable property. Expenditures for current or future net operating income—current expenses and prospective expenditures—result in money's worth in the form of increased net operating income.[194]

Most business expenditures are either current expenses or asset-capitalized expenditures (which constitute most asset-related expenditures).[195] Consequently, the most fundamental aspects of current law (as it applies to businesses) are the rules for the taxation of these expenditures (and associated receipts). There are three essential aspects of this regime. First, and most obviously, an immediate deduction is allowed only for current expenses. Second, in some instances expenditures are capitalized as part of a transaction, while in other instances expenditures are accounted for without regard to the transaction in which they are incurred. Asset-capitalized expenditures, in effect, are paired with either the associated receipt, the asset, or the improvement, so that no profit or loss is shown. This is a transactional form of accounting. If a non-inventory asset is sold, its cost is paired with the sale price to determine profit (or loss) on a transactional basis.[196] In contrast, current expenses are deducted in gross, with no attempt to pair the expenses with associated receipts so as to determine the profit on the transaction in which the expenditures are made.[197] In the case of depreciation, asset-capitalized expenditures are accounted for without regard to the associated receipt, but depreciation is determined with regard to a specific asset, which is a form of transactional accounting. Third, in certain instances, asset-capitalized expenditures are accounted for on the basis of the *expected* future economic consequences of the transaction in which the expenditures are made and not on the basis of

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[194] The only difference between a current expense and a prospective expenditure is in the timing of the receipt. This is not a bright-line distinction. Only the unusual expenditure results in a cash-equivalent receipt at the same time that the expenditure is made. Most expenditures result in a receipt somewhat earlier or later than when made. Consequently, in one sense, there is no such thing as a truly current expense. It is helpful to draw a line between expenditures that will result in a cash-equivalent receipt by the end of the year and other expenditures that will result in receipts at a later point and treat the first type of expenditures as current expenses and the second as prospective expenditures. This article defines intangible capital expenditures as amounts that result in intangible value at year end in order to exclude current expenditures that result in assets or cash equivalents by year end from being treated as intangible capital expenditures.

[195] After the enactment of section 263A, outside the world of intangibles, it is likely that deductible repairs are the principal class of asset-related expenditures that are not capitalized. *See infra* note 221.

[196] The classic case (which may no longer be good law) on when gain or loss is sufficiently "realized" to be taxable is Eisner v. Macomber, 252 U.S. 189 (1920).

[197] The classic case on transactional accounting for operations is Burnet v. Sanford & Brooks Co., 282 U.S. 359 (1931).

the actual consequences. When the expenditures are made, no gain or loss is taken into account, as it is reasonable to expect that the receipt equals the expenditure, although it may not. Depreciation is based on expected, not actual, value losses.[198]

These three aspects of current law are reflected in the statutory language as well as the case and ruling law. The asset-capitalized rules are grounded in section 263(a)(1)[199] and its predecessors (referred to as "section 263" for convenience).[200] This section provides that no deduction is allowed for "[a]ny amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate."[201] The statute focuses on property and requires an expectations-based, transactional analysis. Deductions are not allowed for expenditures made in a *transaction* in which *specific property* is to be acquired or is *expected* to become more valuable.

The Supreme Court interprets section 263 expansively. In *Commissioner v. Idaho Power,*[202] the taxpayer built various facilities itself. It treated many construction-related expenditures, such as wages of construction workers, as nondeductible costs of the facilities, but did not capitalize the amount of depreciation claimed on equipment used in

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[198] Most depreciation currently is determined in accordance with inflexible schedules that presumably reflect congressional expectations. *See* I.R.C. § 168 (West Supp. 1987). This represents a preference, discussed *infra* notes 327-29 and accompanying text. Under prior law, and currently with respect to those assets not subject to schedular depreciation, however, expectations control nonpreferential depreciation, and changed expectations can occasionally be reflected on a prospective basis. *See* Treas. Reg. §§ 1.167(a)-1, -9 (as amended in 1960); Rev. Rul. 74-154, 1974-1 C.B. 59.

[199] I.R.C. § 263(a)(1) (West Supp. 1987).

[200] There may be additional authority for the asset-capitalized rules. For instance, the Court, in Commissioner v. Lincoln Savings & Loan Association, 403 U.S. 345, 354 (1971), disallowed the deduction of asset-related expenditures without regard to section 263 under the requirement of section 162 that a deductible expenditure must be an "ordinary" expense. *See infra* notes 224-27 and accompanying text. Similarly, the Seventh Circuit noted in dictum that perhaps any nonrecurring item may be disallowed under the "ordinary" requirement. *See* Encyclopaedia Britannica, Inc. v. Commissioner, 685 F.2d 212, 216-17 (7th Cir. 1982). A panel of the Fourth Circuit expressly held that an amount could be capitalized under the "ordinary" requirement as interpreted in Welch v. Helvering, 290 U.S. 111 (1933), even if the amount does not relate to a separate asset, but that opinion was reversed on rehearing en banc. *See* NCNB Corp. v. United States, 651 F.2d 942, 957-59 (4th Cir. 1981), *rev'd on rehearing en banc,* 684 F.2d 285, 287-89 (4th Cir. 1982). *See generally* Gunn, *supra* note 2 (arguing that classification as capital expenditures should not be limited to costs that produce or enhance an asset).

[201] I.R.C. § 263(a)(1) (West Supp. 1987). The 1913 income tax act used essentially the same language. *See* Revenue Act of 1913, Pub. L. No. 63-16, § II(B), 38 Stat. 114, 167 (1913). This basic language can be traced to T.D. 1606, 13 Treas. Dec. Int. Rev. 39, 43 ¶ 52 (1910), interpreting the 1909 corporate income tax that contained no similar language. To the same effect are Treas. Reg. §§ 1.263(a)-2(a) (as amended in 1960), 1.461-1(a) (as amended in 1967).

[202] 418 U.S. 1 (1974).

construction. The Court, in an opinion written by Justice Blackmun, held that "[c]onstruction-related depreciation is not unlike expenditures for wages for construction workers. . . . It is . . . appropriately recognized as a part of the taxpayer's cost or investment in the capital asset."[203]

In the 1986 Act, Congress enacted new section 263A,[204] which, as to tangible property, pushes *Idaho Power* to its logical consequence and requires the capitalization of all direct and indirect costs of self-constructed property.[205] The provision was enacted (a) to clearly reverse certain pre-*Idaho Power* cases that did not require the capitalization of some overhead and (b) to ensure uniform capitalization rules for inventory and non-inventory property.[206]

When faced with uncertainty, section 263A reflects a very flexible approach to transactional analysis. Pure transactional accounting would magically follow a specific dollar of depreciation to the specific asset it enhanced. This obviously cannot be done. Ad hoc rules that apportion indirect and similar costs among self-produced assets are the best that can be done.[207] The Finance Committee contemplated this necessity:

> The uniform capitalization rules will be patterned after the rules applicable to extended period long-term contracts . . . . The existing long-term contract regulations provide a

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[203] *Id.* at 13-14.

[204] Tax Reform Act of 1986, Pub. L. No. 99-514, § 803, 1986 U.S. CODE CONG. & ADMIN. NEWS (100 Stat.) 2350.

[205] *See* I.R.C. §§ 263A(a)(1)(B), (b)(1) (West Supp. 1987). *See generally* Schneider & Solomon, *New Uniform Capitalization and Long-Term Contract Rules,* 65 J. TAX'N 424, 425-27 (1986). Section 263A applies to most production period interest. *See* I.R.C. § 263A(f) (West Supp. 1987). Section 189 of prior law required ten-year depreciation of real property construction period interest and taxes (except on low-income housing). *See* I.R.C. § 189 (1982 & Supp. III 1985), *repealed by* Tax Reform Act of 1986, Pub. L. No. 99-514, § 803(b)(1), 1986 U.S. CODE CONG. & ADMIN NEWS (100 Stat.) 2350, 2355. One interesting question is why *Idaho Power* did not require capitalization of construction period interest and taxes. Dictum in a footnote in the opinion can be read to exclude interest and taxes from capitalization. *See Idaho Power,* 418 U.S. at 18 n.13. The footnote is based on the premise that section 266 allows an immediate deduction, which it does not, and therefore the footnote should be given no weight. *See* S. SURREY, P. MCDANIEL, H. AULT & S. KOPPELMAN, FEDERAL INCOME TAXATION, 492-93 (1986). Congress apparently felt that interest and taxes were not subject to mandatory capitalization when it enacted section 189. *See* STAFF OF THE JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, at 25-26 (1976). Congress may have sensed intuitively that interest may not stand on the same footing as other costs. *See supra* note 20.

[206] *See* S. REP. No. 313, 99th Cong., 2d Sess. 133, 136-37, 140 (1986). The first temporary regulations under section 263A make clear that they do not apply to selling expenses. *See* Temp. Treas. Reg. § 1.263A-1T(b)(2)(iii)(L) (1987).

[207] The Tax Court, in Fort Howard Paper Co. v. Commissioner, 49 T.C. 275, 283, 286-87 (1967), recognized that an accounting method is required to identify costs subject to capitalization.

> large measure of flexibility to taxpayers in allocating indirect costs to contracts inasmuch as they permit any reasonable method of allocation authorized by cost accounting principles. The committee expects that the regulations under [section 263A] will adopt a similarly liberal approach . . . .[208]

The section 263A temporary regulations for allocating indirect costs to inventory allow various ad hoc methods "so long as the method employed for such allocation reasonably allocates indirect costs . . . ."[209]

Section 263A also deals with uncertainty by respecting expectations. For example, the depreciation of Idaho Power's construction equipment did not necessarily result in an equivalent increase in the value of the power facilities. In fact, the relationship between expenditures and the offsetting asset value is necessarily more speculative with self-produced assets or improvements than with purchased property, because when an asset is purchased there is a market transaction that indicates value. In *Idaho Power,* the Supreme Court did not acknowledge this as a significant problem because it assumed that any loss (or gain) on an asset should be taken into account later. The Court was not troubled by this result, because it tacitly assumed that Idaho Power expected to get its money's worth, hence failure to account more accurately during construction was not unfair.[210]

Similar reasoning appears to underlie section 263A. The Finance Committee Report to the 1986 Act criticizes prior law because "the existing rules may allow costs that are in reality costs of producing, acquiring, or carrying property to be deducted currently, rather than capitalized into the basis of the property and recovered when the property is sold or as it is used by the taxpayer."[211] Implicitly, "costs" of property should be capitalized, without regard to whether there is an associated value increase.

Different accounting for current expenses and asset-capitalized expenditures is not required in order to tax net income. The classic definition of economic net income (for a year) is consumption (during the

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[208] S. REP. No. 313, 99th Cong., 2d Sess. 141-42 (1986).

[209] Temp. Treas. Reg. § 1.263A-1T(b)(3)(iii) (1987).

[210] There are a variety of other ways to view *Idaho Power.* For example, Keller, *The Capitalization of Construction Costs: Expanding the Scope of* Idaho Power, 62 TAXES 618, 630 (1984), emphasizes that *Idaho Power* puts self-constructed assets on a tax footing closer to that of purchased assets. While this certainly is correct, I believe that the analysis in this text is the most complete analysis of the economics of *Idaho Power. See Idaho Power,* 418 U.S. at 14. My analysis is more in line with the purposes of section 263A. *See supra* notes 205-06 and accompanying text.

[211] S. REP. No. 313, 99th Cong., 2d Sess. 140 (1986).

year) plus the increase in wealth (during the year).[212] In the case of a business that retains all earnings but otherwise raises no new capital, this can be simplified to defining income as equal to the business's increase in value.[213] This base can be calculated as follows: At the end of each year, the business (assets and non-asset intangible capital) would be appraised. Any increase (or decrease) from the appraisal at the end of the preceding year would be the business's taxable income (or loss).[214] This regime measures economic net income on a value basis, not by using cash flow,[215] as under current law.[216] Since this regime takes no account of flows, identical accounting is provided for all expenditures. Current law departs from this ideal, but still approximates, ignoring preferences, a tax on economic net income.[217]

It is possible to create a regime that goes to the other extreme—all expenditures accounted for on an expectations, transactional basis. Income would be determined on a transaction-by-transaction basis, with all expenditures (including depreciation) assigned to a transaction based on expectations so as to determine the profit on the transaction, with no separate deduction for current expenses. This regime also would approximate a tax on economic net income.

The current rules seem preferable to the alternatives for three rea-

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[212] *See* BLUEPRINTS, *supra* note 74, at 27-32; Goode, *The Economic Definition of Income,* in COMPREHENSIVE INCOME TAXATION 1, 7-10, 28-30 (J. Pechman ed. 1977). For insightful analyses of various approaches to income, see Andrews, *Personal Deductions in an Ideal Income Tax,* 86 HARV. L. REV. 309, 318-25 (1972); Kaplow & Warren, *An Income Tax by Any Other Name—A Reply to Professor Strnad,* 38 STAN. L. REV. 399, 399-412 (1986).

[213] This formulation ignores consumption, dividends, other distributions, and contributions. Businesses do not consume, so it is reasonable to ignore this component of the tax base. Issues involving contributions and distributions raise double taxation issues that are beyond the scope of this paper. *See supra* note 4.

[214] Current law approaches this regime in its marked to market accounting for commodities futures contracts and options on futures. *See* I.R.C. § 1256 (1982 & Supp. III 1985 & West Supp. 1987).

[215] There has been a great deal of analysis lately of a cash flow regime for measuring consumption. *See, e.g.,* Andrews, *A Consumption-Type or Cash Flow Personal Income Tax,* 87 HARV. L. REV. 1113 (1974) (proposing that personal consumption be taxed).

[216] Financial accounting, in general, also uses a cash flow approach for determining income. It is recognized, however, that a balance sheet test could be used for financial accounting purposes. T. FIFLIS, H. KRIPKE & P. FOSTER, ACCOUNTING FOR BUSINESS LAWYERS 127 (3d ed. 1984) [hereinafter FIFLIS].

[217] *See* Goode, *supra* note 212, at 24-26. This result ignores preferences. *See infra* notes 327-56 and accompanying text. The preferences for saving (IRAs, pension and profit sharing plans) and investment (accelerated depreciation) are so substantial, that, taking these into account, the tax looks nearly as much like a wage tax as a tax on income. (Income is basically wages plus the return to savings and investment.) The classic work noting the "halfway house" result is Andrews, *supra* note 215, at 1128-40. *See infra* note 239.

sons.[218] In each case, the reason relates to the tax system coming to grips with an uncertainty—uncertainty in valuations, uncertainty in identifying the consequences of transactions, or uncertainty in evaluating expectations. First, the current rules avoid difficult valuations. A tax system based on yearly valuations probably would not be workable.[219] The current cash flow rules approximate economic net income without a need for valuations. Increases or decreases in value generally are not taken into account until "realized" in a transaction that indicates value.[220] For example, transactions in which asset-capitalized expenditures are made result in an asset or increase in value that is particularly difficult to value. In fact, expectations are that the receipt equals the expenditure. Current law therefore does not attempt to measure profit or loss at the time the expenditures are made (in cash flow terms, it assumes that the receipt equals the expenditure), but takes any profit or loss into account when the asset generates cash-equivalent revenues, either by being sold or by being used in current operations. The receipt and associated expenditures are effectively ignored until later. In contrast, operating receipts are treated as gross income and current expenses are deducted. The contribution of operations to any change in the business's value is easily measurable, since any change is the result of transactions. The most significant exception to the principle that changes in value are taken into account only when realized in a measurable transaction is depreciation. Without depreciation, a cash flow tax with a realization convention would vary too much from a tax on economic net income. The need for valuations to determine depreciation is avoided, however, by basing depreciation on expectations.[221]

Second, the current rules are appropriate because of the differing degrees of feasibility in adopting transactional accounting in various contexts. In the case of most asset-related expenditures, it is easy to

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[218] A fourth reason is that realization accounting reduces the liquidity problems that would result from taxing unrealized gains. *See* Shakow, *supra* note 4, at 1167-71. This policy concern is never taken into account in evaluating capitalization issues, because capitalization, by itself, does not generate a tax. For this reason, I also do not take liquidity concerns into account.

[219] *But see* Shakow, *supra* note 4, at 1118-67 (arguing that yearly valuations might be workable).

[220] *See* M. CHIRELSTEIN, *supra* note 78, at 69-71. For an analysis of the realization notion in the financial accounting context, see FIFLIS, *supra* note 216, at 152-240.

[221] Next to intangible capital, the line between a deductible repair and an improvement that must be capitalized has presented the most problems for the current capitalization rules. *See* Treas. Reg. § 1.162-4 (1958). *See generally,* M. CHIRELSTEIN, *supra* note 78, at 103-07 (analyzing the regulations that provide that expenditures that extend the life of a property are capitalized and expenditures spent for maintenance are deducted). This is a situation where valuation is unworkable and yet expectations provide little help.

identify the receipt associated with a given expenditure. The expenditure and receipt can be paired so as to determine profit or loss (assumed to be zero) on the expenditure transaction. In contrast, for a given current expense there is no way to determine the related receipt. For example, in the case of a retail store, it is unworkable to allocate a salesperson's salary to specific sales and determine profit or loss on a transaction-by-transaction basis. It is more feasible to treat a tax year as one big transaction, with gross revenues treated as income without regard to the associated expenses, and with gross expenses related to the current year deducted, so that the difference between aggregate gross revenues and aggregate gross expenses indicates the total profit from operations. Similarly, in the case of depreciable property, there is no ready way to match the asset-capitalized expenditures with operating receipts, so a gross deduction is advisable. Depreciation is workable because it is possible to estimate the expected value losses of an identified asset.

Third, the current regime respects practical limits on the utility of expectations accounting. Expectations are central to an income tax, since an income tax on business is ultimately a tax on changes in value, and value is a function of market expectations of the future cash flow to be generated by the business.[222] Current law takes expectations into account at the time asset-capitalized expenditures are made by, in effect, assuming that the receipt equals the expenditure. Similarly, depreciation is feasible only because of expectations accounting. Although determining actual losses of value often would not be feasible, it is possible to determine the effect time is expected to have on an identified asset. Sometimes, however, expectations do not lend themselves to sound tax rules. For example, current law does not respect expectations with regard to current expenses. The expectation at the time the expenditures are made is that the expenditures will increase net current revenues by a roughly equal amount. It also is expected, however, that current revenues will return a profit (return to capital or labor) as well as repay the expenditures. There is no way to separate out the current revenues associated with expenditures from those that represent a profit. Consequently, with respect to current operations, it is best to ignore expectations and tax results.

In short, the current general rules for the taxation of current expenses, asset-capitalized expenditures, and associated receipts appear to be the best way to structure a tax on business income in light of uncertainties in valuations, transactional accounting, and expectations ac-

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[222] *See supra* notes 23-24 and accompanying text.

counting. The question then arises as to the treatment of prospective expenditures. Prospective expenditures are a form of intangible capital expenditure. Consequently, their treatment is considered below in the discussion of (a) the reasons for the current specific rules that result in the three problems with the taxation of intangible capital and (b) the proposal for business intangible capital taxation reform.

B. *Implicit Preference for Preferred Intangible Capital*

The basic rules for current expenses and asset-capitalized expenditures reflect an approach that, when faced with uncertainty, respects expectations and is not overly concerned with precise transactional accounting. Unfortunately, the special rules that control the taxation of asset-capitalized expenditures at the time the expenditures are made are based on a non-expectations, transactional, asset-oriented approach. This inflexible approach is responsible for the implicit preference for preferred intangible capital.

It is not possible to adopt rules for intangible capital expenditures that are mechanically inconsistent with the general regime just discussed. For example, it would not be possible to apply the economic income appraisal regime described above only to intangibles.[223] Similarly, it would not be reasonable to allow a deduction for all intangible capital expenditures in the year the expenditures are made and tax the associated receipt (intangible asset or value increase), given that this is not done with tangible asset expenditures. Current law adopts rules for intangible capital that are mechanically consistent with the general regime, but that provide a current deduction for intangible capital expenditures unless they are directly allocable to an identifiable, separate asset in a specific transaction.

The concerns underlying the present rules can be seen in the opinion of the Supreme Court in *Commissioner v. Lincoln Savings & Loan Association,*[224] an opinion three years before *Idaho Power,* also written by Justice Blackmun. In *Lincoln Savings,* the taxpayer savings and loan tried to deduct a payment into a special fund held by the

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[223] Congress has had difficulty limiting the current marked to market rules, referred to *supra* note 214. The original 1981 provision applied only to regulated futures contracts. *See* Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, § 503(a), 95 Stat. 172, 327 (1981). Because of the similarity of these contracts to "interbank contracts," the rules were expanded in 1982 to cover interbank contracts. *See* Technical Corrections Act of 1982, Pub. L. No. 97-448, § 105(c)(5), 96 Stat. 2365, 2385 (1983); S. REP. No. 592, 97th Cong., 2d Sess. 26 (1982). In 1984, the rules were expanded to some options. *See* Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 102(a)(2), 98 Stat. 494, 620 (1984).

[224] 403 U.S. 345 (1971).

F.S.L.I.C. The taxpayer had a partially transferable interest in its share of the fund, that is, its deposits plus associated earnings. Under certain circumstances, the F.S.L.I.C. could use the fund to pay losses, but otherwise the taxpayer's share of the fund would benefit the taxpayer, either by being returned in cash or by being applied against amounts owing for F.S.L.I.C. insurance. In an easy case, the Court held that the payments were not deductible. It is not the holding, but the analysis and dicta in the case, however, that are significant. The Court did not rest its holding on section 263, apparently considering section 263 inapplicable.[225] It merely held that the payment did not satisfy the basic requirement of deductibility that an expenditure be an "ordinary" expense.[226] This alone would have expanded the scope of capitalization. Partially in dicta, however, the Court noted:

> [T]he presence of an ensuing benefit that may have some future aspect is not controlling; many expenditures concededly deductible have prospective effect beyond the taxable year. . . . What is important and controlling, we feel, is that the . . . payment serves to create or enhance for Lincoln what is essentially a separate and distinct additional asset and that, as an inevitable consequence, the payment is capital in nature and not an expense, let alone [a deductible] ordinary expense. . . .[227]

Somewhat surprisingly, courts generally have interpreted this as narrowing the scope of capitalization, including narrowing section 263's application, by adding a requirement that nondeductible expenditures must relate to a "separate and distinct additional asset."[228] This language ensured the continued vitality of the old cases on advertising, R&D, etc., discussed above, which reflect a similar analysis.[229]

Lincoln Savings suggests the reasons for its asset-oriented approach. Under the current cash flow regime, all gross operating reve-

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[225] *See Lincoln Sav.*, 403 U.S. at 358. Gunn suggests that the statutory language implies that section 263 applies only with respect to tangible property. *See* Gunn, *supra* note 2, at 448.

[226] *See supra* note 200.

[227] *Lincoln Sav.*, 403 U.S. at 354.

[228] *See* Central Texas Sav. & Loan Ass'n v. United States, 731 F.2d 1181, 1185 (5th Cir. 1984); *see also* NCNB Corp. v. United States, 684 F.2d 285, 288-89 (4th Cir. 1982); Iowa-Des Moines Nat'l Bank v. Commissioner, 592 F.2d 433, 436 (8th Cir. 1979); Colorado Springs Nat'l Bank v. United States, 505 F.2d 1185, 1192 (10th Cir. 1974); Briarcliff Candy Corp. v. Commissioner, 475 F.2d 775, 782-85 (2d Cir. 1973). *Contra* Cleveland Elec. Illuminating Co. v. United States, 7 Cl. Ct. 220, 225 (1985). *See generally* Lee, *supra* note 2, at 51-57, 64-71.

[229] *See supra* notes 88-107 and accompanying text.

nues are taxable income. In order to ensure that the tax base under this regime approximates net, and not gross, income, an immediate deduction must be available for expenditures related to the current revenues. The Court sees great uncertainty in the determination of the portion of current expenditures that should be deductible immediately. In a vague sense, all expenditures have a future "benefit." If the business stopped making any expenditures, it would cease to operate and there would be no future. The Court did not attempt to look behind this problem and try to define what expenditures economically should be capitalized. It recognized that it could not solve the problem by pairing intangible capital expenditures with specific receipts. The Court therefore leaped upon the asset/non-asset line. Outside the world of intangible capital, this line polices an immediate deduction fairly well. It was natural for the Court to extend the asset/non-asset line to intangible capital expenditures, equating the asset/non-asset line with the deduct/no-deduct line.

Section 263A and the *Lincoln Savings* analysis, as reflected in the case itself and the earlier case law on advertising, R&D, etc., are key contributors to the implicit preference for preferred intangible capital. Most tangible, asset-related expenditures are capitalized under section 263A. Other expenditures are immediately deductible unless they "enhance . . . a separate and distinct additional asset."[230] Much intangible capital is not a separate and distinct additional asset in any traditional sense. For example, goodwill, while treated as an asset for most tax purposes, is not a separate asset. It cannot be identified by itself, but only when the business changes hands or otherwise is valued.[231]

The *Lincoln Savings* analysis does more than invoke an asset-ori-

[230] I.R.C. § 263A (West Supp. 1987). Section 446(b) grants the Secretary of the Treasury broad powers to change a taxpayer's accounting method if it does not "clearly reflect income." I.R.C. § 446(b) (1982 & Supp. III 1985). *See generally* Gunn, *supra* note 2, at 452-65 (discussing why the cost of an asset may not be immediately deductible under section 446(b)). This has been used to require a taxpayer to defer the deduction of amounts associated with intangible capital. For example, section 446 imposes limitations on a cash basis taxpayer's deduction of prepayments that can operate independently of the separate asset disallowance. *See, e.g.,* Commissioner v. Boylston Mkt. Ass'n, 131 F.2d 966, 968 (1st Cir. 1942) (holding that prepaid insurance is a capital expenditure and can only be deducted over the life of the policy). The panel decision in *NCNB* relied on section 446(b). *See NCNB,* 651 F.2d at 954-55. Some believe that the courts can read section 446 to solve most of the issues addressed in this Article. *See, e.g., Deductibility, supra* note 2, at 635-39 (arguing that the capital/expense distinction should be drawn by reference to the clear reflection of income test). The cases and rulings discussed *supra* notes 69-107, 228, however, suggest that section 446(b), at least in its current form, is not able to overcome the *Lincoln Savings* separate asset notion. Consequently, this Article generally assumes that section 446(b) does not require deferral of all preferred intangible capital deductions.

[231] *See supra* notes 88-107, 145-47 and accompanying text.

ented approach. It implicitly adopts a narrow, transactional perspective. The quotation suggests that the Court assumes that one can determine that a "payment serves to create or enhance . . . a separate and distinct additional asset" only on a transactional basis. A specific expenditure must relate to a specific asset. The uncertain nature of intangible capital makes the application of a transactional analysis quite difficult. Consider advertising. Assuming that the intangible capital related to advertising is a separate and distinct asset, for example, a trademark, there is no clear method for determining which or how much advertising enhances the asset.[232] The difficulty in applying a transactional approach results in many intangible capital expenditures being deductible, exacerbating the implicit preference. This is borne out in the cases and rulings regarding specific types of intangible capital expenditures, discussed above.[233] For example, little advertising that enhances a trade or service mark is capitalized, because of the difficulty in linking a given expenditure to the mark. The Senate version of the 1986 Act would have applied section 263A with respect to intangibles,[234] while the Act itself applies the capitalization rules only to tangibles.[235] It seems possible that the problems in allocating expenditures to intangibles might have motivated the conferees to avoid the issue by excluding intangibles from section 263A.

There is an additional aspect implicit in the *Lincoln Savings* analysis. Because of the uncertain nature of intangible capital, expectations can have little play, since the expectations with many intangible capital expenditures, that is, prospective expenditures, usually are not directed at a specific asset. For example, the financial institution marketing surveys discussed above,[236] while clearly expected to result in intangible capital, probably do not relate to anything normally thought of as an asset. The Fourth Circuit, therefore, allowed a deduction for the surveys.[237]

The *Lincoln Savings* analysis, on the one hand, and section 263A

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[232] One cannot work backwards by seeing how much the intangible increased in value and assume that this amount of advertising must be capitalized because there is no ready way to value the intangible. *See* Richmond Hosiery Mills v. Commissioner, 29 F.2d 262, 263 (5th Cir. 1928), *cert. denied,* 279 U.S. 844 (1929).

[233] *See supra* notes 88-107 and accompanying text.

[234] The 1986 Senate Finance Committee Report, in its discussion of H.R. REP. No. 3838, 99th Cong., 2d Sess. § 302 (1986), indicated that *Lincoln Savings* was to control for purposes of determining whether an expenditure relates to a separate asset. *See* S. REP. No. 313, 99th Cong., 2d Sess. 141 (1981).

[235] *See* I.R.C. § 263A(b)(1) (West Supp. 1987).

[236] *See supra* notes 83-87 and accompanying text.

[237] *See* NCNB Corp. v. United States, 684 F.2d 285, 288 (4th Cir. 1982). *See also supra* notes 83-87 and accompanying text.

and *Idaho Power,* on the other, illustrate markedly different approaches to uncertainty. When tangible property, or traditional, separate intangibles, such as patents, are involved, section 263A and *Idaho Power* stretch transactional and expectations analysis. In the case of intangibles, as illustrated by *Lincoln Savings,* a perceived greater uncertainty[238] results in a non-expectations, narrowly transactional, asset-oriented approach. This inflexible approach to uncertainty creates the implicit preference for preferred intangible capital. A narrow approach is attractive because it reduces the valuation, transactional accounting, and expectations accounting problems that motivate the basic current regime. Allowing an immediate deduction for all business and individual investment expenditures would go even further towards advancing these goals. Unfortunately, ignoring borrowing, this would effectively eliminate the tax on income associated with these investments, as the present value of the tax savings from the immediate deduction would approximate the future taxes on receipts (including interest) to be generated by the investments.[239] This generally is considered an unacceptable result under an income tax.[240] Some valuation and related problems are unavoidable.

Two historical flukes also contributed to the development of current law.[241] First, the earliest cases involving advertising were litigated in a reversed posture, with the taxpayers arguing for capital treatment.[242] These cases involved taxable years subject to the World War I excess profits taxes. Taxpayers could reduce their tax (a) by trying to capitalize pre-war advertising and depreciate the capitalized amounts in the high tax rate war years or (b) by treating advertising as "invested capital" so as to reduce the amount of excess profits subject to high rates of tax.[243] As a result, the I.R.S. developed an anti-capitalization

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[238] This perception is illustrated nicely by the following quotation from a leading legal accounting text: "Because of their lack of physical characteristics, and their tendency to be sui generis, a great deal more uncertainty is involved in solving . . . [financial accounting] questions for intangibles than for other assets." J. COX, FINANCIAL INFORMATION, ACCOUNTING, AND THE LAW: CASES AND MATERIALS 381 (1980).

[239] For an interesting discussion of this result, see W. ANDREWS, BASIC FEDERAL INCOME TAXATION 528-30 (3d ed. 1985).

[240] *Cf.* 1 TREASURY I, *supra* note 4, at 105-09 (discussing capital consumption allowances). An immediate deduction is allowed under a cash flow consumption tax on individuals. This simplification of the tax on capital income is one of the principal advantages of the personal consumption tax. *See id.* at 195-97. The personal consumption tax has been rejected for other good reasons, however. *See id.* at 211-12. It has never received serious congressional consideration.

[241] *See* B. BITTKER, *supra* note 2, at ¶ 20.4.5.

[242] *See, e.g.,* Northwestern Yeast Co. v. Commissioner, 5 B.T.A. 232 (1926).

[243] *See* Revenue Act of 1918, Pub. L. No. 65-254, §§ 300-328, 40 Stat. 1088-93 (1919); Excess Profits Tax, War Revenue Act of 1917, Pub. L. No. 65-50, § 203, 40 Stat. 304 (1917). Also, the NOL rules were not enacted until 1918, so that prior to that

bias. Since taxpayers generally have the burden of proof on factual issues (like capitalization) in a tax controversy,[244] the I.R.S. position pushed the courts in an anti-capitalization, anti-investment direction. By the time the shoe was on the other foot, the I.R.S. was faced with bad judicial precedent that it had helped create. Interestingly, as discussed below,[245] Congress provided elective capitalization for much advertising and other promotional expenditures under the later (World War II and Korean War) excess profits taxes.

Second, the regulation severely limiting the depreciation of intangibles was promulgated in 1919,[246] quite early in the history of the income taxes. With this rule in place, capitalization of intangible capital expenditures leads to the harsh result of effectively no deduction. This certainly influenced the courts to allow an immediate deduction.[247]

C. *Extra Tax*

In a world in which many intangible capital expenditures are deductible, the rule that no depreciation is allowed for nondepreciable preferred intangible capital, combined with the rule that the costs of purchased intangibles must be capitalized, creates an extra tax on sales of businesses with self-developed, nondepreciable preferred intangible capital. These rules also reflect varying responses to the uncertainty associated with intangible capital.

The no-depreciation rule arose primarily as a result of administrative action, a regulation originally promulgated in 1919.[248] It provides that depreciation of intangibles is allowed only for assets useful in the business for "a limited period, the length of which can be estimated

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time taxpayers with start-up losses had an incentive to create a do-it-yourself carry forward by depreciating advertising. *See* Revenue Act of 1918, Pub. L. No. 65-254, § 204, 40 Stat. 1060-61 (1919).

[244] *See* M. GARBIS, P. JUNGHANS & S. STRUNTZ, FEDERAL TAX LITIGATION ¶¶ 12.01[1], 17.03[1] (1985).

[245] *See infra* notes 260-63 and accompanying text.

[246] *See infra* notes 248-56 and accompanying text.

[247] For example, in X-Pando Corp. v. Commissioner, 7 T.C. 48, 51-54 (1946), the court easily rejected the taxpayer's arguments for depreciating advertising, noting the ordinary immediate deduction of such expenditures, and implying that this solved any problems caused by not depreciating them. In a few unusual instances, the courts have disallowed a deduction for expenditures that relate to a nondepreciable intangible. A former employee of a bankrupt corporation who paid debts of the corporation so as to facilitate his new business was allowed no deduction in Welch v. Helvering, 290 U.S. 111, 116 (1933), because the payments were not ordinary. *See supra* note 200.

[248] *See* T.D. 2831, 21 Treas. Dec. Int. Rev. 170, 214 (1919). This regulation explicitly disallowed depreciation of goodwill.

with reasonable accuracy."[249] (There is no issue of depreciating non-asset expenditures since they are immediately deductible.) The regulation places a "reasonably estimable"[250] limited useful life requirement on top of taxpayer expectations of value losses as the standards for determining depreciability.

The concerns underlying the regulation are apparent.[251] Taxpayers want to use short depreciation periods to claim depreciation deductions more quickly and thereby increase the present value of the deductions. There appears to be a greater potential for depreciation abuse with intangibles. In the case of tangibles, there is an upper bound on expected value loss: expected physical wear and tear. This gives some comfort that it is possible to police expectations without looking at values. Any comfort is more apparent than real, however, as taxpayer use may make wear and tear quite unpredictable. In any event, for many intangibles there is no easily verifiable proxy for value that is analogous to tangibles' wear and tear. One simply cannot see goodwill wear out, although it is expected to, and does, lose value.[252] (A business's goodwill holds value due to "improvements" in the form of current expenditures.) A useful life requirement is the closest analogy to wear and tear expectations for intangibles. This supports the limitation of an expectations approach by adding a useful life requirement.[253] A similar analysis probably was the basis for the 1919 regulation. The 1913 income tax allowed depreciation only on assets subject to exhaustion, wear, and tear.[254] Depreciation for obsolescence was enacted in 1918,[255] because

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[249] Treas. Reg. § 1.167(a)-3 (1960).

[250] The "reasonably estimable" gloss is not particularly important and is not considered further. *See* Note, *Amortization of Intangibles: An Examination of the Tax Treatment of Purchased Goodwill,* 81 HARV. L. REV. 859, 874 (1968) [hereinafter *Harv. Note*].

[251] *See* Gregorcich, *supra* note 2, at 254-58; *Harv. Note, supra* note 250, at 871.

[252] One theme running through this area is that goodwill and going concern value never lose value. *See, e.g.,* X-Pando Corp. v. Commissioner, 7 T.C. 48, 54 (1946). All economic evidence indicates that this is not the case. The economic analysis of expenditure-created goodwill and going concern value, *see supra* notes 29-43 and accompanying text, finds fairly short lives.

[253] Looking at a given buyer, a limited life requirement does not appear to be unfair, since most of the costs of "improving" the intangible, which would be capitalized in the case of a tangible asset, might be deductible under the general asset-capitalization rules. *See supra* notes 69-107 and accompanying text. This overstated improvement deduction compensates for understated depreciation.

[254] *See* Revenue Act of 1913, Pub. L. No. 63-16, § II(B), 38 Stat. 167 (1913); Schenk, *supra* note 6, at 504-05. The 1909 corporation income tax merely allowed "a reasonable allowance for depreciation of property." Revenue Act of 1909, Pub. L. No. 61-5, § 38, 36 Stat. 113 (1909). One aspect of pre-1918 Revenue Act law must be noted. T.D. 2690, Reg. 33, arts. 162, 167, 168, 20 Treas. Dec. Int. Rev. 203-05 (1918), disallowed depreciation on assets not subject to wear and tear, including goodwill and trademarks, "except patents, copyrights, etc." Apparently the Treasury

of congressional concern for post-war obsolescence.[256] The 1919 regulatory useful life requirement (including no depreciation for goodwill) apparently was an attempt to limit the 1918 legislation. As with the *Lincoln Savings* analysis, a concern for a perceived greater uncertainty associated with intangible capital led to different results for intangibles and tangibles.

The cases and rulings that developed the rules regarding capitalization do not explain why purchased intangible capital must be capitalized, while much self-developed intangible capital is deductible. The reason is fairly apparent, however. With an ongoing business, some expenditures are current expenses. When a business is sold, the consideration paid is for the business and is not a current expense. Ignoring intangible capital, there is no uncertainty whether an expenditure should be capitalized or expensed; the purchase price must be capitalized, the only question is to what account. Simple notions of consistency suggest that intangible capital expenditures should not be immediately deductible, notwithstanding that this requires an expectations approach (assuming that the value of intangible capital equals the amount of intangible capital expenditures). Because there is less uncertainty with purchased intangibles than with self-developed intangibles, purchased intangibles are taxed with an approach closer to that applied to tangibles than that applied to self-developed intangibles.

In short, current law reflects a non-expectations, transactional, asset-oriented approach to the uncertainty in determining the taxation of expenditures to develop intangible capital and in depreciating intangible capital, but adopts a more flexible expectations approach to the lesser uncertainty in capitalizing purchased intangible capital. The hesitancy to apply an expectations approach is understandable, as it is based on the same concerns that motivated the general asset-capitalized rules, but seems to be an overreaction. Worse, the inconsistent approaches result in the extra tax on sales of businesses with self-developed nondepreciable preferred intangible capital.

D. *Preference for Ongoing Businesses*

The implicit preference for ongoing businesses results from the start-up rules—the "carrying on" requirement and section 195. These rules reflect a flexible approach because of a perceived lower level of

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thought that what happens to patents and copyrights is "exhaustion."

[255] *See* Revenue Act of 1918, Pub. L. No. 65-254, § 234(a)(7), 40 Stat. 1078 (1919); Schenk, *supra* note 6, at 504-05.

[256] *See* H.R. REP. No. 767, 65th Cong., 2d Sess. 10 (1918).

uncertainty in the start-up context.

The "carrying on" requirement is attributable in part to the perhaps accidental appearance of the words "carrying on" in the deduction statute.[257] However, as the Claims Court (which does not respect the "carrying on" requirement) has noted about the "carrying on" cases:

> Although the rationale of these decisions is not fully articulated, they appear to accept or assume the underlying theory that where a business requires substantial start-up expenditures before it can begin operations, which are not directly for the purchase of tangible assets and which will not ordinarily be recovered out of revenues for the same year, the capital investment is in the business as a whole rather than merely in the tangibles, and it includes the start-up costs.[258]

Start-up costs must be expected to increase intangible capital even though the capital items cannot be identified on a transactional basis. The Senate Finance Committee report to the 1984 provision making section 195's disallowance mandatory indicates similarly that "[t]he committee believes that start-up expenditures generally result in the creation of an asset which has a useful life which extends substantially beyond the year in which incurred."[259] The approach of Congress and the courts to start-up costs is based on expectations and does not look to transactions.

With a start-up concern, the costs of self-developed preferred intangible capital are easy to identify. Under these circumstances, Congress and the courts are willing to look at expectations, and relax or ignore transactional, asset-oriented modes of analysis. With an ongoing concern, however, the uncertainty is viewed as more troubling, and a wooden approach is taken. In the abstract, the start-up rules come closer to the ideal. Given the general regime for ongoing businesses, however, the start-up rules result in the preference for ongoing businesses.

E. *Conclusions*

The basic rules for the taxation of expenditures (and associated receipts) appear to be preferable to alternative regimes. If it always were possible to identify and value intangible capital and to estimate

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[257] I.R.C. § 162(a) (1982). The 1913 income tax contained "carrying on" language. Revenue Act of 1913, Pub. L. No. 63-16, § II(B), 38 Stat. 114, 167 (1913).

[258] Cleveland Elec. Illuminating Co. v. United States, 7 Ct. Cl. 220, 228 (1985).

[259] EXPLANATION OF PROVISIONS, *supra* note 21, at 282.

accurately the effect time will have on intangible capital, the application of these rules to intangible capital probably would have developed without the current problems. Unfortunately, a great deal of uncertainty is associated with intangible capital, and the non-physical nature of intangible capital has caused policy makers to be particularly leery of this uncertainty. It is easiest to be satisfied of the presence of intangible capital, and of its value only when a business changes hands or in a start-up business. This pushed the law towards a flexible view in these situations (purchased intangibles and start-up costs), but towards a wooden, non-expectations, transactional, asset-oriented view outside these situations (capitalization and depreciation). The resulting patchwork regime is responsible for the three problems with current law.

III. PROPOSAL

A. *The New Approach*

The problems with current law are attributable to its non-expectations, transactional, asset-oriented approach to dealing with various uncertainties associated with intangible capital. It is possible to develop an expectations, nontransactional, non-asset oriented approach that is responsive to the current problems. The approach has precedent in two provisions of current law, section 195 and the research and experimentation credit, and in obscure regulations under the World War II and Korean War excess profits taxes. Under the approach, increased current expenses are deductible only at such time as revenues increase or other expenses decrease.

The basis for a new approach is suggested in regulations under the excess profits taxes in World War II and the Korean War. Taxpayers were allowed to elect to capitalize (and not depreciate) advertising and goodwill expenditures (in the pre-war excess profits tax base period) viewed as capital investments.[260] Such capitalization could be

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[260] *See* 26 U.S.C. § 451 (1952) (Korean War); 26 U.S.C. § 733 (1946) (World War II). The election applies to the excess profits tax base period and all subsequent years and can apply today to a taxpayer that made the historical election. *See* I.R.C. § 263(b) (1982); Treas. Reg. §§ 1.162-14 (1969), 1.263(b)-1(1973). The Senate Finance Committee Report to the Excess-Profits Tax Amendments of 1941 notes:

> This . . . permits a taxpayer . . . to capitalize expenditures for advertising and goodwill promotion made in the base period, which the taxpayer had previously deducted as an expense. Such a provision will prevent hardship to taxpayers who deducted such items at a time when the effect of such deduction on their excess-profits credit could not be foreseen.

S. REP. NO. 75, 77th Cong., 1st Sess. 16 (1941). Congress apparently felt that capitalization was elective, but that relief was required to reopen the pre-war base period years.

more beneficial than expensing, because capitalization increased the excess profits credit (a deduction for normal profits based on pre-war profits or a reasonable return on invested capital) for a number of years taxed at higher rates instead of merely reducing taxable income taxed at low rates in one year, as under-expensing.[261] Under the regulations, capitalization was allowed for expenditures made for the purpose of increasing earning capacity over a substantial period.[262] Capitalization also was permitted for: (i) expenditures to promote the taxpayer in a new territory or to promote a new product during the first year of such promotion and (ii) advertising expenditures in excess of the average amount of such expenditures for the two preceding years ("Increased Advertising").[263] These rules generally follow a transactional, asset-oriented approach and therefore are of little help. The Increased Advertising rules, however, are promising.

The Increased Advertising rules reflect a notion that an increase in expenditures probably represents intangible capital. This notion is in line both with the early cases that treated extraordinary advertising as capital and with the analysis of *Lincoln Savings* and other cases that only "ordinary" expenses are deductible.[264] It adopts the sort of expectations approach implicit in *Idaho Power* and section 263A for all intangible capital. Unfortunately, the Increased Advertising rules do not address the more difficult question of when the capitalized amounts should be deducted.

The expectations perspective underlying section 195 provides the beginning of a solution to the deduction issue. Section 195 operates on the premise that, until the business is operating (which is close to the time it starts earning income), all expenditures are capital. This approach can be applied on an incremental basis. An increase in expenditures should not be deductible until there is an increase in revenues. If there is no current increase in revenues to show for an increase in expenditures, the taxpayer probably expects a commensurate current increase in the (noncash equivalent) value of the business. Otherwise, the taxpayer is throwing money away, and this is not likely.

A similar analysis applies to expenditures that increase future net income by saving future expenses. The current expenditures should not be deductible until the occurrence of the associated future savings.

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[261] *See* 26 U.S.C. §§ 430, 431, 434-36 (1952); 26 U.S.C. §§ 710-14 (1946). Capitalization increased the invested capital credit automatically only under the Korean War version. *Compare* 26 U.S.C. § 437(c) (1952) *with* 26 U.S.C. § 715 (1946).

[262] *See* Treas. Reg. §§ 30.733-2 (1941), 35.733-2 (1944), 40.451-2 (1953).

[263] *See* Treas. Reg. §§ 30.733-2 (1941), 35.733-2(a), (b) (1944), 40.451-2 (1953).

[264] *See supra* notes 200, 247.

When future expenses decline, the current expenditures should be deductible. The Increased Advertising approach can be refined to achieve this result automatically. Nondeducted amounts paid today would be carried forward indefinitely to be deductible in a year in which current expenses decrease.[265]

This general approach is consistent with the three uncertainty-related reasons for the general asset-capitalized rules discussed above. The first reason is a concern for speculative valuations.[266] In the case of an asset-capitalized expenditure, it is better to wait until the receipt of a cash equivalent to determine profit or loss. The same is true for preferred intangible capital. Preferred intangible capital expenditures are either asset-related (but not asset-capitalized) or prospective expenditures.[267] The reason for the current general rules applies directly to asset-related preferred intangible capital expenditures. Prospective expenditures are an even clearer case, since there is no identifiable immediate receipt. Consequently, the proposal provides rules for preferred intangible capital expenditures similar to those for asset-capitalized expenditures.

The second reason for the current general rules is a concern for the limitations on transactional accounting.[268] Current expenses are accounted for in gross because transactional accounting would not be feasible. Similarly, the proposal applies a nontransactional accounting for preferred intangible capital, as transactional accounting would be equally unworkable for preferred intangible capital, particularly prospective expenditures.

The third reason for the current rules is a concern for the limitations on expectations accounting.[269] Asset-capitalized expenditures are not deducted immediately because it is reasonable to assume that the associated receipt is equal in value. The same goes for preferred intangible capital expenditures. Similarly, asset depreciation is based on expectations, as this is the only workable way to structure value loss deductions. For parallel reasons, the proposal provides an expectations-based depreciation with respect to preferred intangible capital.

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[265] The carry over would continue year to year until used up. There is precedent for an indefinite carry forward. *See* I.R.C. §§ 465(a)(2), 704(d) (1982), 469(b) (West Supp. 1987).

[266] *See supra* notes 219-21 and accompanying text.

[267] *See supra* note 80.

[268] *See supra* text following note 221.

[269] *See supra* text accompanying note 222.

B. *Basic Deduction Limitation*

The basic deduction limitation would work as follows: In a given tax year, a taxpayer would determine whether the amount of potential intangible capital-related deductions for the current year exceeds the average amount of such deductions for the three preceding years. Any excess would be deductible only to the extent of the sum of (a) the amount by which the current year's potential intangible capital-related gross income exceeds the average amount of such income for the three preceding years plus (b) 20% of any remaining nondeducted amount.

The amount of potential intangible capital-related deductions for a year would be the total amount of deductions *of any sort* decreased by any NOL carry back or carry forward, interest, any other deduction related to raising capital, individuals' deductions not related to producing income, and cost of goods sold (basically the basis of inventory sold, which is really an adjustment in determining gross income and not a deduction anyway).[270] The reasons for the special rule for interest and the costs related to capital are discussed below.[271] For example, in the case of a regular corporation, the amount of potential intangible capital-related deductions would be the amount on line 27 of Form 1120,[272] decreased by interest and other costs of raising capital (such as depreciation of organizational costs), and increased by any carry forward under the proposal, discussed below.[273] The potential intangible capital-related gross income for a year would equal the gross income for the year (which reflects cost of goods sold and the bases of non-inventory assets sold, including assets sold at a loss, subject to loss limitations). For example, in the case of a regular corporation, the potential intangible capital-related gross income would be the amount on line 11 of Form 1120.

The amount by which the total potential intangible capital-related deductions for the current year exceeds the average of such deductions for the three preceding years ("Increased Deductions") would be de-

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[270] Some of these deductions may not be useful because of the NOL rules. *See supra* notes 189-91 and accompanying text. This is a problem with the NOL rules and not with the proposal.

[271] *See infra* text accompanying notes 302-04.

[272] Line 27 of Form 1120 is the sum of compensation and wages, repairs, bad debts, rents, taxes, interest, contributions, depreciation, depletion, advertising, pension, profit sharing, other employee benefits, and other deductions before any NOL carry back or carry forward. *See* I.R.S. Form 1120-W (FY) (Worksheet) (1987).

[273] This reflects a view that a NOL carry back or carry forward should not be viewed as a current deduction but as part of an averaging device, which apparently is the policy underlying current NOL law. *See* S. REP. No. 313, 99th Cong., 2d Sess. 230-31 (1986).

ductible in an amount equal to the sum of (a) the amount by which the current year's potential intangible capital-related gross income exceeds the average amount of such income for the three preceding years plus (b) 20% of any remaining nondeducted Increased Deductions.[274] In the case of a partnership, the limitation would apply to the partnership and not to the partners. The balance of any nondeducted Increased Deductions would carry forward as a deduction for the succeeding year, subject to the same limits as applied to the later year, effecting an indefinite carry forward.[275] Any nondeducted carry forward balance of Increased Deductions would be deductible when the taxpayer ceased all business operations.

Consider an example: A corporation's Forms 1120 (with a calendar year tax year) show the following information (in thousands of dollars):

Table VI

	Line 11	Line 27
1991	1,000	900
1990	900	700
1989	850	650
1988	800	600

The corporation pays no interest and has no other deductions related to raising capital. It also has no carry forward to 1991 under the proposal.

[274] Rules would be required to source this deduction for foreign tax credit and U.S. tax jurisdiction purposes. These issues generally are beyond the scope of this Article. *See supra* note 4. The obvious source rule, however, would treat these deductions as constituting a pro rata share of the underlying potential intangible capital-related deductions. Any carry forward to future years would also consist of the appropriate pro rata shares, so that deductions carried forward would maintain their source.

[275] Complicated rules control the availability of NOLs and other favorable tax attributes after a change in ownership of the business. *See* I.R.C. §§ 382, 383 (1982 & Supp. III 1985 & West Supp. 1987). These rules basically police the use of acquisitions to increase the deductibility of NOL carry forwards. *See* S. REP. No. 313, 99th Cong., 2d Sess. 230-31 (1986). With respect to the proposal, the controlled-group and acquisitions rules, *see infra* notes 276-79 and accompanying text, should come close to serving this purpose by providing that the three-year averages are determined backwards on a combined basis. As a result, a business combination would increase the deduction of the carry forward only if, looking at the combined businesses separately, one of the businesses expects increased gross income (or decreased deductions) in excess of the other's decreased gross income (or increased deductions) and the other has a carry forward that otherwise would not be used. This is a much more unusual transaction than the combination of a profitable and a loss corporation that motivates the NOL rules. If the unusual combination that increases deductions under the proposal is troubling, rules similar to those under sections 382 and 383 can be developed.

For 1991, the Increased Deductions are 250 (900 − [(700 + 650 + 600) / 3]). The increased potential intangible capital-related gross income is 150 (1,000 − [(900 + 850 + 800) / 3]). Consequently, the Increased Deductions are limited to a deduction of 170 (150 + [0.2 × (250 − 150)]). In other words, the corporation's total deductions are 820 (650 + 170). The nondeducted 80 carries forward as a potential deduction in later years.

For purposes of determining the three-year averages of deductions and gross income, rules would be provided to take into account controlled groups of taxpayers, acquisitions and dispositions of businesses, new taxpayers (fewer than three preceding tax years), and short tax years. These rules would be patterned on the simple rules for determining similar averages for purposes of the research and experimentation credit.[276] The research and experimentation credit is, basically, 20% of the amount by which the current year's qualified research expenses exceed the average such expenses for the three prior years.[277] Consequently, the credit is based on an averaging of prior years, much like the proposal. It, therefore, is appropriate to borrow solutions to problems raised by such averaging for the proposal. For example, the research and experimentation credit controlled-group rules[278] guard against related taxpayers shifting qualified research expenditures between themselves in order to increase the credit artificially.[279] The proposal would adopt this rule to prevent shifting of potential intangible capital-related gross income and deductions.

C. *Start-up Businesses*

The "carrying on" requirement and section 195 would be repealed. Consequently, the only restriction on the deduction of start-up costs would be the limitation on the deduction of Increased Deductions. However, the research or experimental credit new taxpayer rule provides that if the taxpayer has less than three preceding tax years, it will be treated as if it had been in existence for three years with no qualified research during the years it was not in existence.[280] This rule would be adapted to the proposal by providing that a new taxpayer

[276] *See* I.R.C. §§ 41(c) (new taxpayers), (f)(1) (controlled groups), (f)(3) (acquisitions and dispositions), (f)(4) (short years) (West Supp. 1987); Prop. Treas. Reg. §§ 1.44F-3(b), 48 Fed. Reg. 2790, 2794 (1983) (new taxpayers), 1.44F-3(d), 48 Fed. Reg. 2790, 2794 (1983) (short tax years).

[277] *See* I.R.C. §§ 41(a), (c) (West Supp. 1987).

[278] *See* I.R.C. § 41(f)(1) (West Supp. 1987); Prop. Treas. Reg. § 1.44F-6, 48 Fed. Reg. 2790, 2797 (1983).

[279] *See* S. REP. No. 144, 97th Cong., 2d Sess. 83 (1981).

[280] *See* Prop. Treas. Reg. § 1.44F-3(b), 48 Fed. Reg. 2790 (1983).

would be treated as having no potential intangible capital-related gross income or deductions for any year it was not in existence. Consequently, except for the automatic 20% deduction, a start-up taxpayer would get deductions only to the extent of income. This is very similar to the result under current section 195 for start-up taxpayers.[281]

D. *Sales of Businesses*

In a taxable sale of a business, no consideration would be allocated to goodwill or similar nondepreciable intangibles. The seller's nondeducted carry forward balance (appropriately adjusted to the time of sale) would be treated as an asset with a value equal to the amount of the balance.[282] Consequently, an amount of consideration would be allocated to the balance.[283] This consideration would be tax-free to the seller (since the seller's basis in the deemed asset would equal the sale price) and treated as a deduction for the buyer (subject to the new limits). In other words, the buyer would be allowed the seller's carry forward, thus effectively stepping into the seller's shoes with regard to the nondeducted balance.

The question arises as to the treatment when the consideration paid does not equal the sum of the aggregate value of the assets sold plus the seller's nondeducted carry forward balance. No obvious way exists to deal with the situation where the total purchase price falls short of the total value of the assets (and deemed asset). The shortfall may be evidence that the seller's deemed preferred intangible capital (the nondeducted carry forward balance) exceeds the actual value of preferred intangible capital. Rules consistent with this view would: (a) reduce the nondeducted balance by the amount of the shortfall (but not below zero), allowing an ordinary loss[284] for the amount of the reduction; (b) give the buyer a carry forward equal to the seller's balance so reduced; and (c) allocate the consideration among the assets (and the deemed asset, so reduced) proportionately to their respective values.

Consider an example: Seller Corporation sells its entire business operations to Buyer Corporation for $1 million in cash. On the day of the sale, the value of Seller's separately identifiable assets (determined

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[281] I.R.C. § 195 (1982 & Supp. III 1985).

[282] Sales of these deemed assets would be treated generally as asset dispositions, which, for example, qualify for installment reporting under section 453 and treatment as dispositions for purposes of section 904(f)(3).

[283] There is precedent for having a seller provide tax information that is binding on a buyer. When a sports franchise is sold, the seller must tell the I.R.S. the consideration allocated to player contracts and that amount generally is binding on the buyer. *See* I.R.C. § 1056(c) (1982).

[284] More precisely, a section 1231 loss. *See supra* note 152.

by appraisers) is $900,000 and its nondeducted carry forward balance is $150,000. The consideration falls short of the sum of the value of the assets plus the nondeducted balance by $50,000. Under the view that the shortfall is attributable to intangible capital, the $50,000 is allocated to the nondeducted carry forward balance, as if an asset with a $150,000 adjusted basis were sold for $100,000, so that Seller would have a $50,000 loss and Buyer would be allowed only a $100,000 carry forward from Seller.

This regime, however, is not free from problems. The shortfall may not be attributable solely to preferred intangible capital.[285] For example, a shortfall can occur because the assets (including some preferred intangible capital, like human capital) are more valuable in alternative businesses. This type of shortfall represents the costs required to change businesses so as to realize the greater value.[286] Additionally, this regime would accelerate intangible capital deductions, creating a tax reward for sales of businesses with nondeducted carry forward balances.

An alternative regime would continue to treat the nondeducted carry forward balance as an asset worth the amount of the balance. The consideration paid would be allocated proportionately to the value of the assets (and deemed asset), so that a portion of the shortfall would be allocated to the balance along with the assets, resulting in an ordinary loss.[287] The buyer would get a carry forward equal to the seller's nondeducted balance reduced by the portion of the shortfall allocated to the balance. In the example above, this rule would allocate the $50,000 among the assets and the balance. The assets would be treated as sold for $857,000 and the balance as sold for $143,000. Seller would have less gain (or a greater loss) on the assets and a $7,000 loss on preferred intangible capital. Buyer would be treated as having bought the assets for $857,000 and be allowed a $143,000 carry forward. This regime would increase the loss on assets, but decrease the "loss" on the nondeducted carry forward balance, and, because it makes the tax consequences of a sale less dependent on the amount of Seller's nondeducted carry forward balance, it seems more attractive.

It is even less obvious how to treat any excess consideration. An analysis of the possible reasons for an excess is beyond the scope of this Article. It is clear, however, that preferred intangible capital can con-

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[285] The Tax Court appears to have found this to be the case in Concord Control, Inc. v. Commissioner, 78 T.C. 742, 750-52 (1982).

[286] *See* Doernberg & Hall, *supra* note 2, at 374-75.

[287] More precisely, a section 1231 loss. *See supra* note 152.

tribute to an excess.[288] For example, a particularly successful advertising campaign can increase the intangible capital of the business by substantially more than the cost of the campaign. The excess may be attributable entirely to intangible capital. Rules consistent with this view would allocate any excess to the nondeducted carry forward balance, giving the seller gain. A nondeducted carry forward balance equal to the entire amount so allocated would be allowed to the buyer.

Consider an example: Seller Corporation sells its entire business operations to Buyer Corporation for $1 million in cash. On the day of sale, the value of Seller's identifiable assets is $800,000 and its nondeducted carry forward balance is $150,000. There is a $50,000 excess. Under the view that the excess is attributable to intangible capital, the $50,000 would be allocated to the nondeducted carry forward balance, as if an asset with a $150,000 adjusted basis was sold for $200,000, resulting in $50,000 of gain to Seller and a $200,000 balance to Buyer.

One could assume that any excess is not attributable to intangible capital. The nondeducted carry forward balance would be treated as an asset worth its amount and the consideration would be allocated among the assets (and deemed asset) proportionately to their values. In the example above, the $50,000 excess would be allocated: $42,000 to the assets, $8,000 to the nondeducted balance. This would result in Seller recognizing an additional $42,000 of gain (or less loss) on the assets and $8,000 of gain on preferred intangible capital. Buyer would be treated as paying an additional $42,000 for the assets and be allowed a $158,000 nondeducted carry forward balance.

The American Law Institute has suggested a final approach, which provides that any excess would be tax-free to Seller and nondepreciable to Buyer.[289] Applying the American Law Institute approach to the example, Seller would not be taxed on the $50,000, but Buyer would be treated as paying only $800,000 for the assets and be allowed only a $150,000 carry forward from Seller. This regime would ensure

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[288] There is a body of economics literature dealing with the ratio of business value to the replacement cost of assets. This ratio is referred to as "Tobin's q," as it was originally defined in Tobin, *A General Equilibrium Approach to Monetary Theory*, 1 J. MONEY, CREDIT & BANKING 15, 19-20 (1969). Monopoly power can give a high q. *See* Lindenberg & Ross, *Tobin's q Ratio and Industrial Organization*, 54 J. BUS. 1, 29 (1981). Most recognize that failure to include the replacement cost of intangibles in the denominator also contributes to a high q. *See* Hirschey & Weygandt, *supra* note 40, at 328-29; Ross, *Accounting and Economics*, 58 ACCT. REV. 375, 376-78 (1983).

[289] *See ALI, supra* note 4, at 124-25. The ALI would impose two additional requirements for tax-free treatment: (a) that the consideration for the intangibles be received by a corporate seller that distributes the consideration to its shareholders and (b) that the seller have net capital and section 1231 gain. Consideration of the purposes served by these requirements is beyond the scope of this Article.

that preferred intangible capital does not result in an extra tax. For this reason, the American Law Institute's approach seems the most attractive.

The question then arises as to the character of any gain.[290] In order that intangible capital be treated similarly to depreciable tangible personal property, depreciation recapture should apply to any gain, with the excess over recapture treated as capital gain.[291] There is, however, no way to determine the amount of recapture. A recapture calculation requires that one know the amount of deductions attributable to the sold intangible capital. This is not possible. Simplicity therefore suggests that all gain on the nondeducted balance should be ordinary. Because of the buyer's deductions, this probably would result in a smaller extra tax than results under current law.

Current law would apply both for purposes of distinguishing between the sale and lease of an intangible asset and for purposes of distinguishing between a transfer of intangible capital and the provision of services.[292] When these rules result in a transaction being characterized as the sale or other transfer of an asset separately from the business and some portion of the costs of the asset may be attributable to expenditures under the new accounting, there is no obvious way to allocate a portion of any nondeducted carry forward balance to the transfer. A sound rule would be to allocate none. In the case of self-developed intangibles, the same result occurs under current law because these expenditures would have been deducted earlier. The result changes, however, in the case of the resale of purchased nondepreciable intangibles. The new result would treat purchased and self-developed intangibles similarly, which is attractive, but might discourage sales of intangibles compared to sales of tangibles, which is troubling. Fortunately, few intangibles should be subject to the new tax, as it would apply only to separately transferable nondepreciable intangibles, and there are very few of these.[293]

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[290] The gain should be sourced where the associated deductions were incurred. *Cf.* I.R.C. § 865(d)(3) (West Supp. 1987) (gain on goodwill treated as from sources in the country in which it was generated). Arbitrary rules based on the past three years' deductions could be used for this purpose.

[291] More precisely, a section 1231 gain. *See supra* note 152.

[292] *See supra* note 4.

[293] An example of an asset-like nondepreciable intangible is a television network affiliation contract. *See, e.g.,* Forward Communications Corp. v. United States, 608 F.2d 485, 505 (Ct. Cl. 1979) (network affiliation contract nondepreciable). These contracts customarily cannot be assigned.

E. *Design Problems*

The proposal would apply to all deductions. No attempt is made to identify preferred intangible capital on a transactional basis. This is not as unreasonable as it might first appear. Consider promotional expenditures. One can increase future sales revenues in a variety of ways. Salesmen can do long-term promotion, in which case a portion of their salaries is related to intangible capital. One can buy a billboard, in which case the depreciation on the billboard is related to intangible capital. There is no easy way to assure that only those amounts likely to have long-term effects are subject to the new deduction limitation.[294] Additionally, economic evidence indicates that there is a close relationship between the level of all deductible expenditures and the level of intangible capital expenditures.[295]

The proposal contains various arbitrary features. For example, three-year averaging of income and deductions is chosen to conform with the similar average used in determining the research and experimentation credit,[296] and not because of a refined judgment that three-year averaging is best in light of a balancing of manipulability, feasibility, and accuracy. Similarly, the additional deduction of 20% of non-deducted Increased Deductions is arbitrary. Retaining current law for self-developed intangible capital expenditures capitalized under current law and for drawing the sale/lease and transfer/service lines is done for convenience. Each of these features should be scrutinized before the proposal is given serious consideration. In particular, an empirical analysis of how accurately the proposal conforms to the actual econom-

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[294] An interesting analogous problem was presented by Pacific Power & Light Co. v. United States, 644 F.2d 1358 (9th Cir. 1981). Pacific Power was claiming depreciation on equipment used to construct electric distribution facilities. It argued that *Idaho Power* only requires the capitalization of regular depreciation, not the accelerated portion of preferential accelerated depreciation. *See id.* at 1360. The court, however, required the capitalization of all depreciation. *See id.* at 1361. This overstates the tax basis of assets constructed early in the life of the equipment and understates the basis of assets constructed in the later years. The court apparently felt that providing different treatment for the accelerated and regular portions of depreciation was unworkable, at least as a matter of court-made law.

[295] *See* Ben-Zion, *supra* note 1, at 229. Ben-Zion finds a relationship between all deductible expenses (not including interest or depreciation) and advertising plus R&D intangible capital. The proposal assumes a relationship between all deductions (not including interest but including depreciation) and preferred intangible capital. Nevertheless, Ben-Zion's result is evidence that the proposal's assumption is reasonable. It is worth noting that Ben-Zion's result is consistent with the evidence of the varying effects of advertising discussed *supra* notes 29-43 and accompanying text. This is because there is no reason to believe that, even for businesses in which advertising is the principal source of intangible capital, advertising is proportional to total deductions.

[296] *See supra* notes 276-79 and accompanying text.

ics of intangible capital should lead to improvements in the proposal's operation (or, perhaps, to a complete rejection of the proposal).

Under the proposal, the value of services committed to developing intangible capital by owners of non-corporate businesses should be treated as an intangible capital expenditure. For example, an inventor can spend years developing a new patented product. Subjecting the services of partners and proprietors to the new deduction limitation would require that imputed returns to proprietors and partners be treated as potential intangible capital-related deductions. A partial imputation[297] for the earned income of partners and proprietors is frequently required for social security tax purposes,[298] which imputation is used for purposes of the research and experimentation credit.[299] Amounts subject to this partial imputation could be treated as potential intangible capital-related deductions.[300] Under current law, however, no imputed

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[297] The imputation treats a portion of the taxable income of the proprietorship or partnership as earned income. *See* I.R.C. § 1402(a) (1982 & Supp. III 1985 & West Supp. 1987). In a proprietorship or partnership with less taxable income than the true services income for the year, the imputation can understate the true services income from the transaction. Consider a proprietor who is a carpenter and spends an entire year building a house to sell the next year. The proprietorship will have no taxable income, so it will have no earned income. If the proprietor had hired someone else to build the house, the employee would have had taxable wages and the proprietor would have been required to capitalize the wages.

[298] *See* I.R.C. §§ 1401 (1982 & Supp. III 1985), 1402 (1982 & Supp. III 1985 & West Supp. 1987).

[299] *See* I.R.C. § 41(b)(2)(D) (West Supp. 1987).

[300] In order that imputed amounts be treated consistently with wages, the services of the proprietors or partners actually expended in self-production should be treated as additional income to the proprietors or partners. This can be seen by modifying the example in note 296. Assume that the carpenter also had income from performing carpentry for third parties. In this instance, the proprietorship would have earned income. This earned income, however, understates the true services income. If an employee had performed the house construction, the proprietor would have been taxed on the same amount as when the proprietor performed all services herself, because the wages would be capitalized while the carpentry revenues would be taxable, and the employee would have been taxed on her income from her services. There is more taxable income when the employee comes into the picture. When the proprietor performs the self-construction, therefore, she should be taxed on the saved wages as well as any other partnership profits. This is only true because the imputed services should be capitalized. When a partner or proprietor performs deductible services, one need not worry about the imputation, as it would be offset by an identical deduction. (This is why no income imputation is required with respect to the amounts imputed for purposes of the research and experimentation credit.)

The correct imputed income bears no relationship to the partial imputation required for social security tax purposes. The noncorporate business may have relatively little or a lot of owner services tied up in self-production compared to the owner services tied up in generating current taxable income. Imputing additional income equal to the amount of the partial imputation (which already is taxable) would be unacceptably arbitrary. Some formula imputing income to the extent the partial imputation increases the disallowance might be workable. Alternatively, the partial imputation could be treated as a potential intangible capital-related deduction for purposes of determining services capitalization is required in the case of self-constructed tangible assets.[301] The proposal, therefore, does not impute a services return for proprietors and partners.

A similar problem is posed by returns to investors in the business (either as profits or interest). The value of self-produced property should reflect the cost of capital tied up during production as well as expenditures.[302] When the capital is provided by borrowing, this value can be accounted for by treating interest as a potential intangible capital-related deduction. There is no easy way to impute the cost of capital (lost interest) when the taxpayer uses its own funds in (equity finances) the construction. The proposal therefore avoids the issue—it does not try to impute lost income on equity financing and does not treat interest as a potential intangible capital-related deduction. This is inconsistent with the rules for tangible property, which capitalize interest paid but fail to impute interest lost on equity.[303] The proposal therefore views the bias against debt finance that would result from applying the current tangible property rules to intangible capital as more troubling than the resulting treatment—which would favor debt-financed intangible capital over debt-financed tangibles.[304] This judgment is not inherent in the proposal, which could be modified easily to parallel the current treatment of tangibles by treating interest as a potential intangible capital-related deduction.

There are problems in deciding how gains and losses on assets should affect the new deduction limitation. If gains and losses enter the calculation of the deduction limitation, realization accounting would allow taxpayers to manipulate gross income and deductions to avoid the new limitation. Also, it is not clear whether net gains should be potential intangible capital-related gross income with net losses treated as potential intangible capital-related deductions (or as a reduction of gross income), or whether the gross proceeds from sales should be treated as gross income with the adjusted bases of sold assets treated as deductions. Unfortunately, it is not possible to simply ignore gains and losses. Sales of inventory must be taken into account or the determination of potential intangible capital-related gross income would be meaningless. The same is true with respect to inventory-like assets traded to

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the ceiling on current deductions, but the imputation would not be deductible. This at least assures that the imputation not artificially create deductions.

[301] *See* I.T. 2196, IV-2 C.B. 112 (1925).

[302] *See supra* note 20.

[303] *See* I.R.C. § 263A(d) (West Supp. 1987).

[304] *Cf.* Mundstock, *supra* note 15, at 1258-59 (problems with debt-financed accelerated depreciation property are also present with equity-financed property, and thus limitations on debt financing would discriminate against debt finance).

make a profit, such as patents held for sale but not required to be held in inventory. Moreover, the principal assets (other than receivables) held by businesses are depreciable assets.[305] As to these assets, gain, to the extent the sale price does not exceed the original cost (and any loss), reflects overstated (or understated) depreciation. Because depreciation is treated as a potential intangible capital-related deduction, consistency suggests that these related gains and losses also should enter the calculation of the new deduction limitation. In short, most asset dispositions should be taken into account under the proposal. Consequently, it seems best to reflect all gains and losses. The mechanical rules of the proposal (netting out basis in the determination of gross income, subject to current law's loss limitation and related netting rules) was chosen to conform with traditional usage and to simplify calculation of the new limitation on the basis of the current Form 1120.[306] These rules also have the advantage of incorporating the current loss limitation and related netting rules, which should reduce the problems from taxpayer manipulation of realizations.

Another question involving gains and losses is what account should be taken of the favorable rate of tax on capital gain. Current law, for purposes of the foreign tax credit limitation (which is based on taxable income), reduces taxable income from gains and losses so as to reflect the rate preference.[307] This rule could be adapted to the proposal. More analysis of this and similar gains and losses problems would be required before the proposal is given serious consideration.[308] In particular, the potential for abuse of realization accounting might require additional anti-abuse rules.

The final design problem is how to account for new investment in the business. This is the most fundamental problem with the proposal. In order to see this problem, consider an example: In a 10% interest world, a taxpayer expends \$100. If the \$100 generates receipts only the next year, approximately \$110 (\$100 plus 10% interest) should be gen-

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[305] *See* INTERNAL REVENUE SERVICE, *supra* note 113, at 22.

[306] *See* I.R.S. Form 1120-W, *supra* note 272.

[307] *See* I.R.C. § 904(b) (1982 & West Supp. 1987).

[308] For example, it may be necessary to refine the limits on the amounts that may be inventoried. A taxpayer with no increase in potential intangible capital-related gross income would have an incentive to increase inventories so as to increase the deduction of the items added to inventory (to the extent these items are allocated to current sales, particularly with Last-In-First-Out (LIFO) inventory accounting). John Bishop called this problem to my attention. Other taxpayers have no incentive to overstate inventories, however, as increasing inventories reduces the deduction of other items. Also, new section 263A contemplates new regulations that will reduce taxpayer discretion in calculating inventories. *See* S. REP. NO. 313, 99th Cong., 2d Sess. 141-42 (1986). The Temporary Regulations do this somewhat. *See* Temp. Treas. Reg. § 1.263A-1T (1987).

erated in order to repay the $100 plus compensate the taxpayer for the time delay (and risk) in receiving the $100 back. Similarly, if receipts are generated only two years later, approximately $121 of receipts should be generated. The perfect tax treatment of the $100 in these two transactions under the basic approach of the proposal would be, in the first instance, a $100 deduction in the next year and, in the second, a $100 deduction two years later. In fact, under the proposal (ignoring the additional 20% deduction) the additional receipts from the $100 expenditure actually could result (if there are otherwise nondeductible amounts subject to the new deduction limitation), in the first instance, in a $110 deduction in the next year and, in the second, in a $121 deduction two years later. This would occur because the additional potential intangible capital-related gross income would increase the amount of allowable deductions under the new limitation. There is no way to solve this problem perfectly, because, as the example illustrates, the solution, reducing potential intangible capital-related gross income for any interest-like element (by $10 in the first instance and by $21 in the second), requires knowing the year of the related expenditure, which is impossible. Imputing a return on capital, as discussed above, would reduce the problem, but even that much simpler fix seems unworkable and inappropriate, particularly if imputation would apply solely for purposes of the new deduction limitation.

New investment exacerbates this defect. For example, a business that raises new capital and buys a bond increases potential intangible capital-related gross income, and thereby may improperly increase deductions under the new limitation. In fact, any new investment that quickly generates profits artificially increases deductions under the proposal. If an interest-like element were backed out of receipts, this would not happen. More realistically, one could restate prior years' potential intangible capital-related gross income as if the new capital had been in the business earning a market return.[309] The controlled-group rules (to be adapted from the parallel rules for the research and experimentation credit[310]) should in effect do this in many instances. For this reason, the proposal contains no explicit new investment rules. Further analysis of the proposal could well conclude, however, that additional rules are needed to deal with the new investment problem.

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[309] Under the wartime excess profits taxes, rules allowed an increased credit for new capital. *Cf. supra* text accompanying notes 243, 261. This would remove the need for a new taxpayer rule, discussed *supra* note 276 and accompanying text.

[310] *See* I.R.C. § 41(f)(1) (West Supp. 1987).

F. *Advantages*

There are numerous advantages to the proposal. The proposal would be much simpler than current law. Eliminating the "carrying on" requirement and section 195 would simplify the law. Also, reducing the tax significance to an ongoing business of the complicated and confused distinction between nondeductible asset-capitalized expenditures and deductible expenditures (non-asset capitalized treatment no longer means immediate deductibility while asset-capitalized treatment potentially means no deductions at all) would simplify the lives of many taxpayers as well as the I.R.S. Similarly, allowing depreciation for purchased goodwill would reduce the effect of the law pertaining to allocation of the purchase price paid for a business to this intangible. Only if the anti-abuse rules become cumbersome, which is always a possibility, would the proposal not represent a simplification.

The proposal would also reduce most of the equity and neutrality problems with current law. It would reduce the tax differences between preferred intangible capital and other expenditures. While the formula for deducting intangible capital expenditures almost never matches the perfect deduction for the expected decline in value of the business, the proposal should be closer than current law. Current law contains any number of rough approximations—including schedular depreciation.[311] The proposal might be no more inaccurate than these provisions.

Under the proposal, in a sale of a business, consideration allocated to the nondeducted carry forward balance would be tax-free to the seller. To the extent the balance accurately measures the value of preferred intangible capital, the proposal would eliminate the extra tax on the sale of businesses with intangible capital. If the balance exceeds the correct value, capital gain and ordinary income on other assets would be understated (or loss overstated). This tax reduction would compensate the seller for understated intangible capital deductions. It would, however, reward the seller compared to an ongoing business. This result is not that troubling. As noted above, the current rules for depreciation recapture probably result in a small extra tax on business sales.[312] The seller benefit in the proposal would offset the extra tax, although in a haphazard fashion. If the value of any preferred intangible capital exceeds the nondeducted carry forward balance, the excess probably would be reflected by the total consideration exceeding the value of the assets plus the balance. In this case, the American Law Institute rule of

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[311] *See* I.R.C. § 168 (1982 & Supp. III 1985 & West Supp. 1987) (accelerated cost recovery system based on statutorily-fixed depreciation schedules).

[312] *See supra* notes 170-71 and accompanying text.

the proposal, which would make the excess tax-free to the seller and nondepreciable to the buyer, would eliminate the current extra tax.

The new rules would reduce the tax differences between start-up and other businesses.[313] A start-up business would get few deductions until it generates income, much as under current law. However, a conglomerate increasing otherwise deductible expenditures also would get few deductions until it has income to show for the expenditures. In order to deduct new expenditures, the conglomerate could reduce deductions in an old business. The incentive for this is relatively small, as the worst consequence of losing current deductibility would be 20% per year depreciation. Also, there is a good non-tax reason for the conglomerate not to so manipulate its expenditures: cutting back current expenditures should reduce profits.

G. *Disadvantages*

The principal drawbacks of the proposal are that it would unduly reward winners and penalize losers. A business whose gross income increases for reasons independent from expenditures (or whose deductions decrease), a winner, could deduct amounts subject to the new limitation, even when the amounts do not increase current taxable income. Similarly, a business whose gross income decreases for reasons independent from expenditures (or whose deductions increase), a loser, could not deduct as much of its amounts subject to the new limitation as other businesses, even when the amounts increase taxable income.

The winner's problem is not as bad as it first appears. Under current law, an ongoing business can deduct many intangible capital expenditures that are not deductible to a start-up business. The winner's benefit under the proposal can be viewed as the current start-up problem scaled back and spread around more evenly. This does not mean that one should ignore the problem, but the winner's benefit seems sufficiently small compared to similar problems under current law eliminated by the proposal that the problem should not of itself cause one to reject the proposal. Moreover, if the winner's problem is viewed as sufficiently troubling, the deductions otherwise resulting from a large (e.g., 20%) increase in revenues (or decrease in deductions) could be limited, e.g., only half this year with the other half carried forward. Restricting this additional rule to appropriate cases, however, could be quite complicated.

The loser's problem also is not that troubling. As discussed

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[313] They also would reduce the loss branch problem underlying section 367(a)(3)(C). *See supra* note 142.

above,[314] under current law, a business that generates a NOL and cannot benefit from the NOL carry back is only allowed deferred deductions, less valuable in present value terms, for the NOL in later years.[315] The proposal would reduce NOLs by limiting otherwise allowable deductions, softening this effect, while enacting a similar effect, the loser's penalty, for profitable businesses that experience business declines. It seems reasonable to conclude that the new effect, while unfortunate, is no worse than the old effect. Additionally, the loser's penalty for a business with increased expenditures is softened by the additional deduction of 20% of otherwise nondeductible expenditures. The loser's penalty on a business whose revenues drop could be reduced by allowing extra deductions for such businesses. It would be difficult, however, to ensure that only sympathetic cases benefit from the extra deduction relief.

Another disadvantage of the proposal is that it would differ from the financial accounting treatment of the same items. For financial accounting purposes, an immediate deduction is required for the costs of developing intangible assets that are not specifically identifiable, that have indeterminate lives, or that inhere in a going concern and relate to the whole concern.[316] Research and development expenditures must be deducted currently.[317] In a purchase of a business, the consideration must be allocated over the assets of the business by their individual value, with any excess treated as goodwill.[318] Purchase intangibles, including goodwill, must be capitalized and depreciated over a period of no longer than 40 years.[319] Start-up costs cannot be capitalized and depreciated.[320]

There are two reasons not to be overly concerned about the different accounting. First, the approach underlying the financial accounting suffers from many of the same defects as the approach behind current tax law. The very types of expenditures that must be deducted, such as

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[314] *See supra* notes 189-91 and accompanying text.

[315] *See* I.R.C. § 172 (1982 & Supp. III 1985 & West Supp. 1987).

[316] *See* INTANGIBLE ASSETS, Accounting Principles Board Opinion No. 17, ¶ 24 (Am. Inst. of Certified Pub. Accountants 1970) [hereinafter APB 17].

[317] *See* ACCOUNTING FOR RESEARCH AND DEVELOPMENT COSTS, Statement of Financial Accounting Standards No. 2, ¶ 12 (Fin. Accounting Standards Bd. 1974) [hereinafter FAS 2] ("All research and development costs encompassed by this Statement shall be charged to expense when incurred.").

[318] *See* BUSINESS COMBINATIONS, Accounting Principles Board Opinion No. 16, ¶¶ 68, 87 (Am. Inst. of Certified Pub. Accountants 1970).

[319] *See* APB 17, *supra* note 316, at ¶¶ 24-31.

[320] *See* ACCOUNTING AND REPORTING BY DEVELOPMENT STAGE ENTERPRISES, Statement of Financial Accounting Standards No. 7, ¶ 10. (Fin. Accounting Standards Bd. 1975) [hereinafter FAS 7]. The Board is more sensitive to parallel reporting for start-up and going businesses than Congress or the courts. *See id.* at ¶ 30.

those that do not relate to specific assets, indicate an asset-oriented approach. Similarly, financial accounting has a non-expectations, transactional perspective. For example, the Financial Accounting Standards Board, in justifying an immediate deduction for R&D, noted:

> Because there is generally no direct or even indirect basis for relating costs to revenues, the Board believes that the principles of "associating cause and effect" and "systematic and rational allocation" cannot be applied to recognize research and development costs as expenses. . . . Indeed, the general lack of discernable future benefits at the time the costs are incurred indicates that the "immediate recognition" principle of expense recognition should apply.[321]

In the same statement, the Board acknowledged that although any given R&D expenditure may not result in a receipt, R&D programs are undertaken for future benefits. Nevertheless:

> The Board believes . . . that it is not appropriate to consider accounting for research and development activities on an aggregate or total-enterprise basis for several reasons. For accounting purposes the expectation of future benefits generally is not evaluated in relation to broad categories of expenditures on an enterprise-wide basis but rather in relation to individual or related transactions or projects.[322]

As these quotations demonstrate, financial accounting also adopts a non-expectations, transactional approach. This approach, much like the traditional tax approach, makes it difficult to deal with intangible capital.

Second, the differing purposes underlying financial accounting and tax law support different treatments. Problems in accounting for intangible capital arise because of various uncertainties. Tax policy and financial accounting have radically different approaches to uncertainty. A principal concern of accountants auditing income statements is to ensure that profits are not overstated. One of the central maxims of financial accounting is "conservatism"—in the face of uncertainty, adopt the least optimistic treatment, the treatment that shows the smallest profit (or greatest loss).[323] The tax law generally rejects conservatism. As the

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[321] FAS 2, *supra* note 317, at ¶ 49.
[322] *Id.* at ¶ 52.
[323] *See* QUALITATIVE CHARACTERISTICS OF ACCOUNTING INFORMATION, Statement of Financial Accounting Concepts No. 2, ¶¶ 91-97 (Fin. Accounting Standards Bd. 1980).

Supreme Court has noted, "the accountant's conservatism cannot bind the Commissioner in his effort to collect taxes."[324] The financial accounting for intangible capital generally is consistent with conservatism (deductions are taken as early as possible), while the proposal is more consistent with tax accounting notions.

As different approaches to uncertainty support differing rules, different attitudes towards the appropriateness of accounting seeking to approximate economic income also support varying treatments. Some believe that, because the purpose of financial accounting is to provide useful information, the current financial accounting rules are sound, as they, rather than an economically correct method, provide the most useful information.[325] The neutrality criterion requires that tax accounting comport with economics as much as possible.[326] In short, the different policies motivating tax and financial accounting justify the differences between the proposal and financial accounting.

IV. Preferences, Penalties, and Inflation

A. *Introduction*

The discussion thus far has considered only one tax preference, the special treatment of capital gain. A complete analysis of the taxation of intangible capital requires a consideration of a variety of preferences, both those that apply to intangible capital and those that do not, but do have an effect on the tax system that should be taken into account in considering the taxation of intangible capital. The discussion first examines those tangible capital preferences and then reviews the intangible capital preferences. This is followed by a consideration of (a) the one existing tax penalty on intangible capital expenditures and (b) the effect taking inflation into account has on the analysis. One thing becomes clear from this review: The proposal, by reducing the current problems, rationalizes the analysis of other issues related to intangible capital.

B. *Accelerated Depreciation*

Current law provides accelerated depreciation on most tangible de-

[324] Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 543, (1979).

[325] *See* FAS 2, *supra* note 317, at ¶ 50; Ross, *supra* note 288, at 379-80.

[326] *See, e.g.*, Samuelson, *supra* note 79, at 606 (arguing that rapid depreciation, because it fails to reflect the real putative decline in economic value, will interfere with the optimization of market decisions and hence the discounted valuation of assets).

preciable assets.[327] Accelerated depreciation provides larger deductions in the early years of an asset's life (and less in later years) than would be allowed under depreciation intended to approximate the asset's expected decline in value. The earlier deductions are more valuable in present value terms and, therefore, increase the present value of the after-tax cash flow generated by the asset as compared to that derived under regular depreciation.[328] Accelerated depreciation was enacted for a variety of purposes, including to encourage the acquisition of covered property, to stimulate investment, and to enhance saving.[329]

The relationship of accelerated depreciation to the taxation of intangible capital depends on how accelerated depreciation is viewed. If accelerated depreciation is viewed as a tax preference for the specific assets for which accelerated depreciation is allowed, no modification of the above analysis is necessary. The implicit preference for intangible capital is unacceptable because it undercuts the explicit preference by providing greater tax benefits for preferred intangible capital expenditures (immediate deduction) than for expenditures on assets subject to accelerated depreciation (accelerated, but still deferred, deductions).[330] If one believes in a preference for the assets subject to accelerated depreciation, one is not happy to discover that preferred intangible capital is even more favored. Thus, no modification to the proposal is required.

The analysis changes if accelerated depreciation is viewed as an investment incentive, a saving incentive, or a normal part of the tax system. Expenditures associated with intangible capital represent investment, just like expenditures to purchase a machine. Both are expenditures now for increased future revenues. Consequently, an evenhanded investment incentive would give the same tax preference to intangible capital as to property subject to accelerated depreciation. Similarly, if one believes that accelerated depreciation is a saving incentive, similar treatment should apply to investment in intangible capital. Finally, a parallel conclusion is reached if one views accelerated depreciation as a normal part of the tax system.[331] In this case, a tax regime

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[327] *See* I.R.C. § 168 (1982 & Supp. III 1985 & West Supp. 1987).

[328] An immediate deduction is the ultimate form of accelerated depreciation. Consequently, the "preference for intangible capital" example, *supra* text accompanying notes 76-79, illustrates the economics of accelerated depreciation.

[329] *See* S. REP. No. 313, 99th Cong., 2d Sess. 95-96 (1986). For a discussion of the distinction between savings and investment, see R. LIPSEY & P. STEINER, ECONOMICS 505, 542 (4th ed. 1975).

[330] This statement must be tempered somewhat. Accelerated depreciation on a very long-lived asset can be more valuable than expensing of a very short-lived asset. Consequently, expensing of short-lived intangible capital might not be more of a preference than some tangible asset accelerated depreciation.

[331] *See, e.g.,* OFFICE OF MANAGEMENT AND BUDGET, EXECUTIVE OFFICE OF

with economic effects similar to those of accelerated depreciation should apply to the taxation of intangible capital.

There are a variety of ways to modify the proposal to provide a regime for intangible capital that would approximate accelerated depreciation more closely. One possibility would provide that the 20% automatic additional deduction be changed to some greater amount, for example, 50% of the nondeducted increased deductions. Alternatively (or additionally), the deduction triggered by increased revenues (or decreased expenditures) could be greater than the revenue increase (or expenditure decrease), for instance, two times the revenue increase (or expenditure decrease). For purposes of these rules, in a sale of a business, the allocations to intangible capital would be determined under the non-accelerated proposal. The seller would treat the resulting gain, the difference between the accelerated deductions allowed and the deductions it would have claimed under the non-accelerated proposal, as ordinary (recapture) income. The buyer would be allowed a carry forward equal to the carry forward the seller would have had without acceleration.

These regimes would have a number of advantages over current law. They would be simpler than current law. The current biases for preferred intangible capital and for ongoing businesses would be reduced. Although these regimes would effect an extra tax on sales of businesses with preferred intangible capital, the extra tax would be smaller than currently exists. Any extra tax would result from the decision to accelerate depreciation, and not from the taxation of intangible capital. As suggested above, when depreciation exactly tracks the decline in value of the asset, there cannot be an extra tax on the sale of the asset.[332] Accelerated depreciation makes an extra tax possible by ensuring that the adjusted basis of an asset is less than the asset's value. Consequently, an extra tax on preferred intangible capital cannot be avoided if the taxation of preferred intangible capital is to approximate the taxation of asset-capitalized expenditures.

C. *Research or Experimental Expenditures*

The best known preference that applies to intangible capital expenditures is section 174,[333] the provision enacted in 1954 in part to reduce the uncertainty caused by the application of the asset-capitalized

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THE PRESIDENT, *supra* note 120, at G-7.

[332] *See supra* notes 166-70 and accompanying text.

[333] I.R.C. § 174 (1982 & West Supp. 1987).

rules to R&D.[334] Section 174 provides that a taxpayer may deduct "research or experimental expenditures" unless it elects to depreciate the expenditures pro rata over a period of not less than 60 months.[335] In addition, sections 195 and 263A do not apply to section 174 amounts.[336] The Supreme Court has held that the "carrying on" requirement does not apply to section 174 amounts.[337] Besides reducing uncertainty, section 174 was intended to encourage R&D and to ensure that start-up businesses can deduct R&D that would be deductible by an ongoing concern.[338]

The proposal would address, in a more comprehensive fashion, the concerns of reducing uncertainty and minimizing the preferred position of ongoing businesses. It would not eliminate the uncertain asset/non-asset line, as does section 174 for covered expenditures, but would reduce the significance of the line sufficiently that it might not be necessary to have a special R&D provision along with the proposal.[339] The proposal would not, however, by itself provide a preference for R&D. This could be done by providing an immediate deduction for research or experimental expenditures and excluding them from the new deduction limitation.[340] Under these circumstances, the effectiveness of the preference would be improved, as it would give more favorable treatment to R&D than other preferred intangible capital expenditures,[341] not merely equal treatment, as is done currently.[342]

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[334] *See supra* notes 102-03 and accompanying text.

[335] I.R.C. §§ 174(a), (b) (1982).

[336] *See* I.R.C. §§ 195(c)(1) (1982 & Supp. III 1985), 263A(c)(2) (West Supp. 1987).

[337] *See* Snow v. Commissioner, 416 U.S. 500, 504 (1974) (holding that taxpayer was entitled to research and experimentation deduction despite having no sales during the tax year).

[338] *See id.* at 503-04; S. REP. No. 1622, 83d Cong., 2d Sess. 33 (1954); H.R. REP. No. 1337, 83d Cong., 2d Sess. 28 (1954).

[339] Section 174 merely substitutes the line between covered and noncovered expenditures for the asset/non-asset line. Section 174's line may not be much simpler than the asset/non-asset line. *See infra* note 341.

[340] Current section 174 provides elective depreciation for any period of 60 months or longer. *See* I.R.C. § 174(b) (1982). This enables businesses that do not have sufficient income in the years the expenditures are made to move the deductions into later, higher income years when the deductions may be more valuable. Since 1954, however, the general NOL rules, *supra* notes 189-91 and accompanying text, have become so generous that it does not seem necessary to provide special rules for research or experimental expenditures.

[341] The different treatment will require a more careful definition of research or experimental expenditures. This has proved to be a real problem for purposes of the research and experimentation credit. *See* H.R. REP. No. 426, 99th Cong., 1st Sess. 178 (1985).

[342] Some portion of the deduction could be treated as a preference for minimum tax purposes.

An additional preference for R&D exists—the research and experimentation credit, as discussed above.[343] The credit was enacted to encourage R&D.[344] It could be continued along with, and operate separately from, the proposal.[345]

D. *Employment Preferences*

Current law provides two preferences that encourage employment: the earned income credit and the targeted jobs credit. The earned income credit is a refundable tax credit allowed to qualified low-income persons (with dependents) who have small amounts of wages or other earned income.[346] It was enacted in 1975 to compensate for the perceived regressive effects of the social security taxes on low-income workers with dependents;[347] however, it has evolved into tax welfare for the working poor with dependents.[348] The targeted jobs credit is allowed to employers with respect to wages of qualified newly hired workers.[349] It was enacted in 1977 to relieve unemployment.[350] To the extent, if any, encouraging employment encourages employer intangible (human) capital, these credits are related to business intangible capital.[351] Because both credits are essentially separate from the rest of the tax system, they could be continued under the proposal if desired.[352]

E. *Circulation Expenditures*

One final provision is arguably a preference for intangible capital: section 173, the special deduction for circulation expenditures discussed above.[353] It was enacted to eliminate the uncertainty created by the application of the asset-capitalized rules to these amounts.[354] Conse-

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[343] *See supra* notes 276-78 and accompanying text.

[344] *See* S. REP. No. 144, 97th Cong., 1st Sess. 76-77 (1981).

[345] The credit generally is viewed as inefficient. *See* Mansfield, *The R&D Tax Credit and Other Technology Policy Issues,* 76 AM. ECON. REV. 190, 190-91 (1986).

[346] *See* I.R.C. §§ 32(a), (c)(1) (1982 & West Supp. 1987).

[347] *See* S. REP. No. 36, 94th Cong., 1st Sess. 33 (1975).

[348] *See* EXPLANATION OF PROVISIONS, *supra* note 21, at 859.

[349] *See* I.R.C. §§ 51-52 (1982 & West Supp. 1987).

[350] *See* S. REP. No. 66, 95th Cong., 1st Sess. 64-66 (1977).

[351] *See* Stephan, *Federal Income Taxation and Human Capital,* 70 VA. L. REV. 1357, 1377-79 (1984) (suggesting that these preferences can be viewed as relating to employee human capital because encouraging employment nurtures the development of "basic employment skills" that constitute human capital).

[352] U.S. DEP'T OF LABOR & U.S. DEP'T OF TREASURY, THE USE OF TAX SUBSIDIES FOR EMPLOYMENT 4-7 (1986) concludes that there is little evidence that either credit achieves its objective well.

[353] *See* I.R.C. § 173 (1982 & Supp. III 1985 & West Supp. 1987); *see also supra* note 94 and accompanying text.

[354] *See supra* note 94 and accompanying text.

quently, accepting the stated congressional intent, section 173 would be needed less under the proposal, because the proposal would take pressure off the asset/non-asset line. If the proposal is viewed as an inadequate simplification, the special provision could be continued along with the proposal (subject to the new deduction limitation).

F. *Human Capital Preference*

Some believe that a preference for employer human capital expenditures is desirable.[355] This could be done in the same fashion as with R&D, a special deduction or a credit. In either case, the goal of encouraging employer investments in human capital would be advanced compared to current law. Human capital expenditures would be treated more favorably than other preferred intangible capital expenditures. This would represent a greater incentive than exists currently, as there is no special benefit to human capital expenditures compared to other preferred intangible capital expenditures.[356]

G. *Grassroots Lobbying and Similar Expenditures*

A complete analysis of the taxation of intangible capital requires a review of the one tax penalty that can apply to intangible capital. Expenditures related to grassroots lobbying, political campaigns, and similar activities of influencing government (other than with respect to legislation of direct interest to the business) are nondeductible without regard to the asset-capitalized rules.[357] The analysis underlying the disallowance is that it is unfair to let businesses influence government with deductible expenses while the ordinary citizen must lobby or campaign with after-tax dollars.[358] This disallowance could be continued

[355] *See* Schultz, *supra* note 4, at 145. Section 127 allows employees to exclude from income certain employer educational assistance payments. *See* I.R.C. § 127 (1982 & Supp. III 1985 & West Supp. 1987). If the employee education solely benefited the employer, the business human capital with which this Article is concerned, the employee probably would have no income anyway on an agency theory or under the de minimis fringe exclusion. *See* I.R.C. § 132(a)(4) (Supp. III 1985). Consequently, the object of section 127 is employee human capital outside the scope of this Article. A similar analysis applies to the exclusion of employer-provided accident and health insurance under section 106. *See* I.R.C. § 106 (1982 & West Supp. 1987).

[356] Some portion of the deduction could be treated as a preference for minimum tax purposes.

[357] *See* Treas. Reg. § 1.162-20(c) (as amended in 1969); *see also* Cammarano v. United States, 358 U.S. 498, 510 (1959) (finding Treasury Regulation prohibiting deduction of lobbying expenses to "have acquired the force of law").

[358] *See Cammarano,* 358 U.S. at 513. This analysis is defective. The correct analysis is that, because businesses generally make after-tax expenditures, disallowing the deduction of grassroots lobbying, etc., is a tax penalty on this type of business expendi-

under the proposal.

H. *Inflation*

The discussion to this point has not considered the effects of inflation on the tax system. However, the same basic analysis applies once inflation is taken into account. Inflation results in the overstatement of income when current revenues measured in terms of a large number of the current, cheap dollars are offset by deductions measured in terms of fewer, more valuable dollars.[359] Depreciation is measured using historical cost and therefore is understated in an inflationary environment. The nondeducted carry forward balance under the proposal that is deducted in later years also would be understated in an inflationary economy.

Preferred intangible capital should be subject to the same inflation adjustment rules as assets. If depreciation of assets is not adjusted for inflation, no adjustment should be made with respect to depreciation of preferred intangible capital. Any adjustment with respect to preferred intangible capital would provide an implicit tax preference. This preference would violate the equity and neutrality criteria. Similarly, if depreciation of assets is adjusted for inflation, so should depreciation of preferred intangible capital. This could be done under the proposal by restating the nondeducted carry forward balance to reflect inflation.

Inflation poses one additional problem for the proposal. In an inflationary environment, potential intangible capital-related gross income will increase automatically over historical averages, potentially increasing deductions in an artificial manner. This is offset by the reverse effect with potential intangible capital-related deductions, which also will automatically grow, thus increasing the amount of deductions subject to the proposal's new limitations. The error that results when the two effects do not offset exactly does not seem sufficiently troubling to merit some sort of inflation adjustment. No similar adjustment is provided for purposes of the research and experimentation credit, where any inflationary error is entirely in the taxpayer's favor. If this problem is troubling, one can restate prior years' income and deductions used for calculating the new deduction limitation to reflect inflation.

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ture. *See* Cooper, *The Tax Treatment of Business Grassroots Lobbying: Defining and Attaining the Public Policy Objectives,* 68 COLUM. L. REV. 801, 810-13 (1968).

[359] *See* Aaron, *Inflation and the Income Tax: An Introduction,* in INFLATION AND THE INCOME TAX 1, 10-12 (H. Aaron ed. 1976).

CONCLUSION

Recognized defects exist in the current rules for the taxation of business intangible capital. Two misunderstandings apparently underlie the failure of Congress and the courts to address these defects. First, lawmakers may not appreciate the significance of the defects. Second, lawmakers may believe that no workable solutions to the defects are available. This Article addresses both of these misunderstandings.

First, by fleshing out the extent and consequences of three defects—an implicit preference for much intangible capital, an unjustified extra tax on sales of businesses with intangible value, and an implicit preference for ongoing concerns—this Article demonstrates that the current regime is quite troubling and requires attention. Second, this Article shows that the failure of current law to deal with business intangible capital can be explained as well by current law's implicit, wooden, transactional, asset-oriented approach as by the intractable nature of the associated problems.

This Article presents a legislative proposal that addresses most of the current defects. While the proposal has a number of disadvantages, it demonstrates that the current defects may be cured if a nontransactional, non-asset oriented approach is adopted. Policy makers should re-evaluate the taxation of business intangible capital, as real improvement could result.